Auditing – Principles and Practice
This book is a part of the course by Jaipur National University, Jaipur. This book contains the course content for Auditing – Principles and Practice.

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<tbody>
<tr>
<td>AAS</td>
<td>Auditing and Assurance Standards</td>
</tr>
<tr>
<td>APR</td>
<td>Annual Percentage Rate</td>
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<tr>
<td>APY</td>
<td>Annual Percentage Yield</td>
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<tr>
<td>ARDC</td>
<td>Agriculture Refinance and Development Corporation</td>
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<tr>
<td>AS</td>
<td>Accounting Standard</td>
</tr>
<tr>
<td>ATM</td>
<td>Automated Teller Machine</td>
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<tr>
<td>BC</td>
<td>Business Correspondent</td>
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<td>BF</td>
<td>Business Facilitator</td>
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<tr>
<td>BPT</td>
<td>Bombay Public Trusts Act</td>
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<tr>
<td>BSE</td>
<td>Bombay Stock Exchange</td>
</tr>
<tr>
<td>CA</td>
<td>Chartered Accountant</td>
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<tr>
<td>CAE</td>
<td>Chief Audit Executive</td>
</tr>
<tr>
<td>CAG</td>
<td>Comptroller and Auditor General</td>
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<tr>
<td>CARO</td>
<td>Companies Audit Report Order</td>
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<tr>
<td>CCI</td>
<td>Controller of Capital Issues</td>
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<tr>
<td>CCIL</td>
<td>Clearing Corporation of India limited</td>
</tr>
<tr>
<td>CD</td>
<td>Certificate of Deposits</td>
</tr>
<tr>
<td>CDSL</td>
<td>Central Depository Service Limited</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Finance Officer</td>
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<tr>
<td>CII</td>
<td>Chartered Insurance Institute</td>
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<td>CP</td>
<td>Commercial Paper</td>
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<td>CRISIL</td>
<td>Credit Rating and Information Services of India Limited</td>
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<td>CRR</td>
<td>Cash Reserve Ratio</td>
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<td>DFHI</td>
<td>Discount and Finance House of India</td>
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<td>DFI</td>
<td>Development Financial Institutions</td>
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<td>EBT</td>
<td>Electronic Benefit Transfer</td>
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<td>EMS</td>
<td>Export Marketing Services</td>
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<td>EPRA</td>
<td>Earnings Prospects and Risk Analysis</td>
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<td>ETF</td>
<td>Exchange Traded Funds</td>
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<td>EXIM</td>
<td>Export-Import Bank of India</td>
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<td>FCA</td>
<td>Function Configuration Audit</td>
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<td>FCCB</td>
<td>Foreign Currency Convertible Bonds</td>
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<td>Foreign Institutional Investors</td>
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<td>GBDT</td>
<td>Central Board of Direct Taxes</td>
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<td>Global Depository Receipts</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<td>ICAI</td>
<td>Institute of Chartered Accountants of India</td>
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<td>ICICI</td>
<td>Industrial Credit and Investment Corporation of India</td>
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<td>ICRA</td>
<td>Investment Information and Credit Rating Agency of India Limited</td>
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<td>ICT</td>
<td>Information and Communication Technology</td>
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<td>ICWAI</td>
<td>Institute of Cost and Works Accountants of India</td>
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<td>IDBI</td>
<td>Industrial Development Bank of India</td>
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<td>IFCI</td>
<td>Industrial Financial Corporation of India</td>
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<td>IIBI</td>
<td>Industrial Investment Bank of India</td>
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<tr>
<td>IRDP</td>
<td>Institute of Rural Development Planning</td>
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<tr>
<td>IT</td>
<td>Information Technology</td>
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<tr>
<td>LAF</td>
<td>Liquidity Adjustment Facility</td>
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<td>LFAR</td>
<td>Long form Audit Report</td>
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<tr>
<td>LIC</td>
<td>Life Insurance Corporation</td>
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<tr>
<td>LLC</td>
<td>Limited Liability Company</td>
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</table>
MCI - Micro Credit Institution
MMMF - Money Market Mutual Fund
MSS - Market Stabilisation Scheme
NABARD - National Bank for Agriculture and Rural Development
NBFC - Non-Banking Financial Companies
NCFM - NSE’s Certification in Financial Markets
NDS - Negotiated Dealing System
NDTL - Net Demand and Time Liabilities
NGO - Non Government Organisation
NOC - No Objection Certificate
NPA - Non-performing Assets
NPO - Not-for-Profit Organisations
NREGA - National Rural Employment Guarantee Act
NSDL - National Securities Depository Limited
NSE - National Stock Exchange
OMO - Open Market Operations
OTCEI - Over The Counter Exchange of India
PCD - Partly Convertible Debentures
PF - Provident Fund
PoS - Point of Sale
PPF - Professional Practice Framework
PSU - Public Sector Undertakings
RBI - Reserve Bank of India
RRB - Regional Rural Banks
SAI - Special Audit Initiative
SAP - Standard Auditing Practices
SAS - Statement of Auditing Standards
SCRA - Securities Contracts (Regulation) Act
SEBI - Securities and Exchange Board of India
SEC - Securities and Exchange Commission
SFC - State Finance Corporations
SHG - Self Help Groups
SIDBI - Small Industrial Development Bank of India
SIDC - State Industrial Development Corporations
SLR - Statutory Liquidity Ratio
SME - Small and Medium Enterprise
STPA - Sales Tax Practitioners’ Association
TDS - Tax Deducted at Source
UTI - Unit Trust of India
w.e.f - With effect from
Chapter I
Auditing

Aim
The aim of this chapter is to:

- introduce internal audit
- define auditing
- explicate different types of audits

Objectives
The objectives of this chapter are to:

- elucidate internal control system
- explain auditing documentation
- explicate the auditing standards

Learning outcome
At the end of this chapter, you will be able to:

- understand the audit process
- identify the limitations of audit
- describe the need for auditing
1.1 Introduction

Judgement on recorded aspect was a practice prevalent in the ancient time itself as a means of checking. It has its own limitations and also in a grade form. The progress marked by the advent of double entry system of double entry system of book keeping. The pace got accelerated by the large scale production as a result of industrial revolution. The process of checks and counters check of public account popularised. Scope of auditing expands towards mercantile transaction also. Separation of ownership and management necessitates the need to uphold the authenticity of correctness of accounts. Modern business world adopts the auditing work with professionalism.

The Indian companies Act of 1913 made it obligatory for registration of companies the annual audit of its accounts. Act rules laid down latest stipulates scope, duties and responsibilities of the auditor. Professional institutes like institute of chartered account, cost and works accountants, India came into existence. There factors provided a solid and healthy basis for the accounting and auditing profession in India.

Account Auditing in India is known as an examination of financial statements, i.e., balance sheet and profit and loss a/c, books of account and related vouchers so as to help the auditor to form an option as to whether the financial statements show true and fair view of the business affairs or not, and if not, then in what respect it is not showing the true picture of the business activities.

Auditing is done by the auditor to find out whether the financial statements are prepared by business concerns to know the result of the business activity undertaken by them throughout the year, at the end of the business activity undertaken by them whole exercise of accounting.

Definition of auditing

According to general guidelines on internal auditing issued by ICAI, “auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the propositions before him for examination, collects evidence, evaluated the same and on this basis formulates his judgment which is communicated through his audit report.”

The nature of the propositions which an auditor is called upon to review varies. Thus, an auditor may review the financial statements of an enterprise to ascertain whether they reflect a true and fair view of its state of affairs and of its working results. In another situation, he may analyse the operations of an enterprise to appraise their cost-effectiveness and in still another, he may seek evidence to review the managerial performances in an enterprise. In yet another type of audit, the auditor may examine whether the transactions of an enterprise have been executed within the framework of certain standards of financial propriety. However, the variations in the propositions do not change the basic philosophy of auditing, though the process of collection and evaluation of evidence and that of formulating a judgment thereon may have to be suitably modified.

“An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.” The person conducting this process should perform his work with knowledge of the use of the accounting statements and should take particular care to ensure that nothing contained in the statements will ordinarily mislead anybody. The auditor can do this honestly by satisfying himself that:

- The accounts have been drawn up with reference to entries in the books of account
- The entries in the books of account are adequately supported by underlying papers and documents and by other evidence
- None of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements
- The information conveyed by the statements is clear and unambiguous
- The financial statement amounts are properly classified, described and disclosed in conformity with accounting standards
- The statement of accounts taken as an integrated whole, present a true and fair picture of the operational results and of the assets and liabilities.
1.2 Types of Audit

The broad aim of audit is to safeguard the financial interests of the tax payer and to assist the Parliament/State/Union territory legislatures in exercising financial control over the executive. It is the function of the Comptroller and Auditor General to ensure that the various authorities set up by or under the Constitution, act in regard to all financial matters, in accordance with the Constitution and the laws of Parliament and appropriate legislatures and rules and orders issued thereunder. In order to discharge the auditorial duties entrusted by the Constitution to him/her, the Comptroller and Auditor General (CAG) conducts various types of audit, viz., Financial audit, Regularity audit, Receipts audit, Commercial audit, Audit of stores and stock, Performance audit etc. In the performance of this stupendous task, the CAG is assisted by the accounting authorities in various ministries and by the Principal Accounts Officers functioning in various states.

1.2.1 Regularity Audit

Regularity audit consists mainly in checking that the payments have been duly authorised and are supported by proper vouchers in the prescribed form. Its main purpose has been to ensure conformity with the relevant administrative, financial budgetary and accounting rules and regulations provided for in the Constitution or the laws made by Parliament. The objectives of audit against regularity as specified in the Audit code, inter-alia is to ensure:

- that there is provision of funds for the expenditure, duly authorised by competent authority
- that the expenditure is in accordance with a sanction properly accorded and is incurred by an officer competent to incur it
- that the claims are made in accordance with the rules and in proper form
- that all prescribed preliminaries to expenditure are observed, such as proper estimated framed and approved by competent authority for works expenditure, a health certificate obtained, where necessary before disbursement of pay to a government servant
- that the expenditure sanctioned for a limited period is not admitted in audit beyond that period without further sanction
- that the rules regulating the method of payment have been duly observed by the disbursing officer
- that payment has been made to the person and that it has been acknowledged and recorded so that a second claim against government on the same account, is not possible
- that the payments have been correctly brought into account in the original documents

Audit against provision of funds, aims at determining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.

Audit, in relation to audit of expenditure, is to ensure that each item of expenditure is covered by a sanction of the competent authority. Audit against rules and order is an important aspect of regularity audit. It ensures that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. Audit of expenditure against regularity is a quasi-judicial type of work, performed by the audit authorities. It involves interpretation of the Constitution rules and orders.

1.2.2 Financial Audit

Financial audit is one that is conducted in order to ensure that the accounting and financial control systems are efficient and cooperating properly; and that financial transactions have been correctly authorised and accounted for. In other words, it is to ensure that the financial statements and accounts have been prepared to present a true and fair view of the state of affairs of the establishment concerned and in respect of the period covered by the audit. This is the type of audit conducted on the treasury accounts of the Federation from time to time.
Financial audit is the audit conducted by the Indian Audit and Accounts Department to see whether the administrative action of the executive is not only in conformity with prescribed law, financial rules and procedures, but it is also proper and does not result in any extravagance. Financial audit does not concern itself with the audit of administrative organisations and procedures and is different from administrative audit. It is the duty or the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate in waste, extravagance or improper expenditure it is certainly the duty of audit to call specific attention to matters of that kind and to bring the facts to the notice of Parliament. For instance, in a canal project construction, audit would not concern itself with the administrative set-up for the actual construction of the canal and whether it should pass through a particular part of the country or not. These are matters of administration and no scrutiny of these processes will be done by the audit. But if it is found that the alignments had been drawn up on insufficient data, necessitating a subsequent change involving additional expenditure or that the financial results were less than what had been anticipated, then it is the duty of audit to examine the circumstances which resulted in the wrong alignments resulting in loss or avoidable expenditure to the tax payer.

Audit interferes only when administrative action has serious financial implications and is not in conformity with prescribed law, financial rules and procedures. Financial audit also includes audit against propriety or broad principles of orthodox finance. Thus, financial audit safeguards the interests of tax-payer by bringing to the notice of Parliament, wastage in government expenditure.

1.2.3 Receipt Audit

In receipts audit, the function of audit department is to ensure that adequate regulations and procedures have been framed and are being observed by the revenue department, to secure an effective check on assessment, collection and proper allocation of revenue. Since the assessments in a revenue department are of a quasi judicial nature, audit should ensure that the discretion used has been exercised in a judicious manner.

1.2.4 Performance Audit

Financial audit and Regularity audit generally involve scrutiny of individual transactions. They do not focus on the evaluation of a scheme or a programme to which these transactions relate. Therefore, both types of audits have been found inadequate for an evaluation of the performance of an organisation in terms of its goals or objectives.

Ever since the Government launched Five-Year Plans, investment on a large scale has been made on developmental activities for acceleration of socio-economic development of the country. In many cases, the investments did not give the expected returns. Therefore, public has a right to know whether the results achieved had been commensurate with the resources invested. The public concern has found expression in the introduction of performance budgeting in government. The change in the thinking of government, in recent tunes, about the need to relate expenditure to corresponding physical accomplishments made it also to think about the functions of audit. It has been accepted that Regularity audit/Propriety audit is essential for parliamentary control of expenditure. However, in view of the increasing developmental expenditure, under the successive Five Year Plans, audit should examine the achievements of specific programmes, activities and projects in terms of their goals or objectives. It has been felt that audit should bring out those cases where utilisation of resources has been sub-optimal. This has resulted in a serious thought being given to the need for performance audit which is also called efficiency unit.

Performance audit seeks to find out whether the resources have been utilised efficiently by deploying them in an optimum manner. It highlights the extent to which resources are put to productive uses. It also highlights as to what extent quantified benefits could be expected from such deployment of resources.

Although the technique of performance audit is sound and useful, there are many problems in conducting such an audit.

- Firstly, performance evaluation of an activity can be made only in the light of the objectives, which is expected to achieve. Objectives spell out the results desired from an activity. Whereas inputs are easy to measure for an activity, tremendous effort is required to quantify and measure the resulting output, particularly when this output has a social context.
Secondly, according to the concept of Net Welfare, the utilisation of resources has to be optimised not only at the point where they are deployed but also at other points, where the effects of such investments are carried. In other words, investment decisions need to be justified by the application of the technique of social cost benefit analysis.

Thirdly, the objectives of investment are often a combination of financial and nonfinancial factors. There may be situations, when these objectives of public investment which are otherwise considered socially desirable, are found incompatible with immediate financial objectives. For instance, a public undertaking engaged in the production of fertilisers, may have to sell its output at a low price fixed by the government to support agricultural programmes. If the undertaking does not get adequate subsidy from government, its financial results may present a discouraging picture. The undertaking may have served a long-range national objective of achieving self-sufficiency in food production. But in the process, its profits get reduced considerably or it may incur losses. In situations, where the objectives act against financial performance of a public undertaking, it would not be proper to

Fourthly, performance audit presupposes a good information system. A good information system is necessary, to furnish information about what has been actually achieved and at what cost, as against what was planned to be accomplished at a particular cost.

Lastly, effectiveness of performance audit would depend on how best the yardsticks of performance have been evolved. The technique of performance audit can be applied successfully in cases, where norms/standards are available for application. It is easier to apply in manufacturing organisations, than in the case of governmental organisations.

In India, the concept of performance audit is of recent origin. Its scope is unlimited. To conduct performance audit of public undertakings, Audit Boards have been set up. These Boards have been functioning, under the Comptroller and Auditor General, since April, 1969.

The utility of Performance audit can hardly be over-emphasised. It, however, requires expertise in identifying quantifiable objectives in government. It also necessitates framing of precise yardsticks against which the use of resources can be evaluated. In view of these problems, the scope of performance audit in government appears to be at present limited.

1.3 Need for Auditing

The underlying objective of the audit of financial statement is to add credibility to management’s financial statements. Access to capital markets, mergers, acquisitions, and investments in an entity depend not only on the information that management provides in financial statements, but also on the assurance that the financial statements are free of material misstatements. This assurance is provided, to a considerable extent, by an audit. While an audit does not guarantee financial statements’ accuracy, it provides users with a reasonable assurance that an entity’s financial statements give a true and fair view in conformity with the applicable financial reporting framework.

The need for an audit therefore originates from the following factors:

- Conflict of interest
- Unbiased and relevant information
- Complexity of financial information
- Remoteness of the users from the financial information generating system and processes
- Economic consequences of using unreliable information
- Appropriate financial disclosures

In plain and simple terms, an audit enhances users’ confidence that financial statements do not contain material misstatement(s) (on account of a fraud or an error) because these have been examined by a person (the auditor) who is an independent and objective expert who is also knowledgeable about the entity’s business and the applicable financial reporting requirements. In other words, an auditor’s opinion provides an assurance that the financial statements have been prepared and presented fairly.
1.4 Limitations of Audit and Detection of Fraud

The users of the audited financial statements also need to appreciate the inherent limitations of an audit:

- The first limitation of audit is the fact that it is conducted on a test basis since examination of all the transactions of the auditee is neither possible nor practicable. The auditor examines the samples drawn from a population of a class of transactions, analyse its results to form an overall opinion about the entire population of a class of transactions.

- The second limitation of an audit is the fact that much of the audit evidence is persuasive rather than conclusive in nature.

- It is more difficult for the auditor to detect a fraud than an error because fraud usually involves acts designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Unless the auditor’s examination reveals evidence to the contrary, he is entitled to accept representations as truthful and records and documents as genuine. An auditor, however, plans and performs his audit recognising that he may encounter conditions or events during his examination that would lead him to question whether fraud or error exists. Further, while the existence of an effective system of internal control reduces the probability of misstatement of financial information resulting from fraud or error, there will always be some risk of internal controls failing to operate as designed on account of factors such as human error, erroneous design of the control, etc. Furthermore, any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management.

1.5 Auditing Standards

The Auditing Practices Committee (re-christened as Auditing and Assurance Standards Board) was constituted in September, 1982 as one the important technical committees of the ICAI on the lines of the standard setting procedure prevalent abroad. The composition of the Board had been broad based giving representations to RBI, SEBI, CII and Management Institute. The primary objective of the Board, as set out in the Preface to the Statements on Standard Auditing Practices (now renamed as Audit and Assurance Standards), is to review the existing Auditing Practices in India and to formulate the Statements on Standard Auditing Practices which turn are issued under the authority of the Council. While formulating the auditing standards the Board tries to integrate, to the extent possible, the provisions of the International Standards on Auditing issued by the International Federation of Accountants in the light of the conditions and practices prevailing in India. The Board also issues clarifications, Guidance Notes etc. on matters relating to auditing.

During the year under report, the Board issued three industries specific Guidance Notes for the benefit of the members, viz., Guidance Note on Audit of Companies Carrying on General Insurance Business (Revised), Guidance Note on Audit of Companies Carrying on Life Insurance Business and Guidance Note on Audit of Accounts of Members of Stock Exchanges (Revised). These Guidance Notes were issued in collaboration with the Committee on Insurance and the Committee on Financial Markets and Investor’s Protection respectively. The Guidance Note on Audit of Expenses and Guidance Note on Engagements to Perform Agreed upon Procedures were also released during the year.

The Statement on Standard Auditing Practices (SAP) 23 on related Parties and the Statement on Standard Auditing Practices (SAP) 24 ON Audit Considerations relating to Entities Using Service Organisations were also issued during the year.During the year, the Board issued the format of the Auditor’s Report on Consolidated Financial Statements pursuant to the issuance of the Accounting Standard (AS) 21 on Consolidated Financial Statements.

As a major step towards bringing the reporting practices in India at par with the international practices and also as an attempt to bridge the “Expectation Gap”, the Board revised the format of the auditor’s report on financial statements issued in 1958. The revised format clearly brings out, inter alia, the responsibility of the management vis-a-vis the auditor as regards the financial statements, the scope of an audit, the basis of the opinion expressed by the auditor. The revised former evoked positive response from all sections of the society. The Board is also in the process of formulation Statement on Standard Auditing Practices on Auditor’s Report on Financial Statements.
The Statement on Standard Auditing Practices on Risk Assessments and Internal Control has been issued as revised SAP 6. The Board, pursuant to the issuance of the Accounting Standard (AS) 26 ON Impairment of Assets, is in the process revising the Guidance Note on Audit of Miscellaneous Expenditure shown in the Balance Sheet. The Statement on Standard Auditing Practices (SAP) 10 on Using the Work of another Auditor was published in the July, 2002 issue of the Journal. The Board also issued the Exposure Draft of the proposed SAP on Comparatives in July, 2002.

A ICAI Handbook 2002 on Auditing Pronouncements comprising of two volumes, as on July 1, 2002 - Volume of the Handbook containing the text of all the Guidance Notes on matters relating to auditing, which are generic in nature is in the process of release. The Board is also working to bring out Statements on Standard Auditing Practices and Guidance Notes corresponding to the International Standards on Auditing and the International Auditing Practices Statements, issued by the International Federation of Accountants.

During the year, the Board also interacted with the Reserve Bank of India and other governmental and regulatory bodies. In August, 2001, a crisp comparative position of the Indian Accounting Standards vis-a-vis International Accounting Standards and US GAAP was brought out by way of publication title “A comparative Study of Accounting Standards - Indian GAAP, IAS and US GAAP” for providing an up to date reference material to the various users of the financial statements. This publication was revised later taking into account the subsequent Indian Accounting Standards issued.

A sizeable number of background materials have been brought for the seminars and conferences held all over India relating to Accounting Standards and its implications, International Accounting Standards and US GAAP’S Accounting aspects of Disaster Management, etc.

1.6 Internal Audit

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

Roles and opportunities

The internal auditor is involved with:

- Evaluating Emerging Technologies
- Analysing Opportunities
- Examining Global Issues
- Assessing Risks, Controls, Ethics, Quality, Economy, and Efficiency
- Assuring that controls in place are adequate to mitigate the risks
- Communicating information and opinions with clarity and accuracy
- Such diversity gives internal auditors a broad perspective on the organisation.

Internal Auditors are well-disciplined in their skills and subscribe to a professional code of ethics. They are diverse and innovative; committed to growing and enhancing their skills; continually on the lookout for emerging risks and trends in the profession; good thinkers. To effectively fulfill all their roles, internal auditors must be excellent communicators who listen attentively, speak effectively, and write clearly.

Sitting on the right side of the management, today’s internal auditors are consulted on all aspects of the organisation and must be prepared for just about anything. They are coaches, internal and external stakeholders’ advocates, facilitators of risk management, control experts, efficiency specialists and problem solving partners.
1.7 Professional Practices Framework

The Institute of Internal Auditors Inc. provides comprehensive guidance and information for the internal audit activity. Much of it is through the Professional Practices Framework (PPF), a blueprint for the profession that offers a full range of guidance to internal audit practitioners. The Institute’s Board of Directors approved the Professional Practice Framework (PPF) in June 1999. In general, a framework provides a structural blueprint of how a body of knowledge and guidance fit together. As a coherent system, it facilitates consistent development, interpretation, and application of concepts, methodologies, and techniques useful to a discipline or profession. Specifically, the overall purpose of the PPF is to organise the full range of existing and developing practice guidance in a manner that is readily accessible on a timely basis to internal auditors. It also brings additional value to management, corporate governance entities, investors, and all other stakeholders by prescribing practices that access and ensures effectiveness throughout the organisation. In addition, it provides guidance for complying with new laws and regulations. The PPF basically contains:

- Code of ethics: Ethics are inherent in the internal audit process, from operations to risk management to governance. The code is established to promote an ethical culture throughout the profession and not only includes relevant principles and rules of conduct for internal auditors but also presents an enviable benchmark for ethics throughout the organisation.

- Standards: The purpose of the standards is to delineate basic principles that represent the practice as it should be, provide a framework for performing and promoting a broad range of value added activities, establish the basis for measuring performance and foster improved organisational processes and operations. Standards comprise Attribute, Performance, and Implementation Standards. Attribute Standards and Performance Standards apply to all internal audit services. Implementation Standards apply to specific types of engagements, such as, assurance and consulting activities. These are contained within the Attribute and Performance Standards and are identified by either assurance engagements or consulting engagements.

- Practice advisories: The advisories provide sound advice on interpreting and applying the standards. Although they are not mandatory, the practice advisories represent best internal audit practice and are strongly recommended.

- Development and practice aids: It comprises a broad range of practical guidance in the form of professional development conferences and seminars, IIA research foundation research reports, educational products and other select products and services related to the professional practice of internal auditing.

Corporate governance

Corporate Governance may be defined as “A set of systems, processes and principles which ensure that a company is governed in the best interest of all stakeholders.” It ensures Commitment to values and ethical conduct of business; Transparency in business transactions; Statutory and legal compliance; adequate disclosures and Effective decision-making to achieve corporate objectives.

In other words, Corporate Governance is about promoting corporate fairness, transparency and accountability. Good Corporate Governance is simply Good Business. Clause 49 of the SEBI guidelines on Corporate Governance as amended on 29th October, 2004 has made major changes in the definition of independent directors, strengthening the responsibilities of audit committees, improving quality of financial disclosures, including those relating to related party transactions and proceeds from public/ rights/ preferential issues, requiring Boards to adopt formal code of conduct, requiring CEO/CFO certification of financial statements and for improving disclosures to shareholders. Certain non-mandatory clauses like whistle blower policy and restriction of the term of independent directors have also been included.

Besides the Listing Agreement of SEBI, certain provisions of the Companies Act 1956 also have an impact in the Corporate Governance process of the organisation. These provisions should be complied with in addition to clause 49 of the Listing Agreement and in no case supersedes the requirements of the said clause.
1.8 Audit Process

Although every audit project is unique, the audit process is similar for most engagements and normally consists of four stages: Planning (sometimes called Survey or Preliminary Review), Fieldwork, Audit Report, and Follow-up Review. Client involvement is critical at each stage of the audit process. As in any special project, an audit results in a certain amount of time being diverted from your department’s usual routine. One of the key objectives is to minimise this time and avoid disrupting ongoing activities.

Planning
During the planning portion of the audit, the auditor notifies the client of the audit, discusses the scope and objectives of the examination in a formal meeting with organisation management, gathers information on important processes, evaluates existing controls, and plans the remaining audit steps.

Announcement letter
The client is informed of the audit through an announcement or engagement letter from the Internal Audit Director. This letter communicates the scope and objectives of the audit, the auditors assigned to the project and other relevant information.

Initial meeting
During this opening conference meeting, the client describes the unit or system to be reviewed, the organisation, available resources (personnel, facilities, equipment, funds), and other relevant information. The internal auditor meets with the senior officer directly responsible for the unit under review and any staff members s/he wishes to include. It is important that the client identify issues or areas of special concern that should be addressed.

Preliminary survey
In this phase the auditor gathers relevant information about the unit in order to obtain a general overview of operations. S/He talks with key personnel and reviews reports, files, and other sources of information.

Internal control review
The auditor will review the unit’s internal control structure, a process which is usually time-consuming. In doing this, the auditor uses a variety of tools and techniques to gather and analyse information about the operation. The review of internal controls helps the auditor determine the areas of highest risk and design tests to be performed in the fieldwork section. Click here for an annual internal control review plan.

Audit program
Preparation of the audit program concludes the preliminary review phase. This program outlines the fieldwork necessary to achieve the audit objectives.

Fieldwork
The fieldwork concentrates on transaction testing and informal communications. It is during this phase that the auditor determines whether the controls identified during the preliminary review are operating properly and in the manner described by the client. The fieldwork stage concludes with a list of significant findings from which the auditor will prepare a draft of the audit report.

Transaction testing
After completing the preliminary review, the auditor performs the procedures in the audit program. These procedures usually test the major internal controls and the accuracy and propriety of the transactions. Various techniques including sampling are used during the fieldwork phase.

Advice and informal communications
As the fieldwork progresses, the auditor discusses any significant findings with the client. Hopefully, the client can offer insights and work with the auditor to determine the best method of resolving the finding. Usually these communications are oral. However, in more complex situations, memos and/or e-mails are written in order to ensure full understanding by the client and the auditor.
Audit summary
Upon completion of the fieldwork, the auditor summarises the audit findings, conclusions, and recommendations necessary for the audit report discussion draft.

Working papers
Working papers are a vital tool of the audit profession. They are the support of the audit opinion. They connect the client’s accounting records and financials to the auditor’s opinion. They are comprehensive and serve many functions.

Audit report
Our principal product is the final report in which we express our opinions, present the audit findings, and discuss recommendations for improvements. To facilitate communication and ensure that the recommendations presented in the final report are practical, Internal Audit discusses the rough draft with the client prior to issuing the final report. For an audit report template including an executive summary click here.

Discussion draft
At the conclusion of fieldwork, the auditor drafts the report. Audit management thoroughly reviews the audit working papers and the discussion draft before it is presented to the client for comment. This discussion draft is prepared for the unit’s operating management and is submitted for the client’s review before the exit conference.

Exit conference
When audit management has approved the discussion draft, Internal Audit meets with the unit’s management team to discuss the findings, recommendations, and text of the draft. At this meeting, the client comments on the draft and the group works to reach an agreement on the audit findings.

Formal draft
The auditor then prepares a formal draft, taking into account any revisions resulting from the exit conference and other discussions. When the changes have been reviewed by audit management and the client, the final report is issued.

Final report
Internal Audit prints and distributes the final report to the unit’s operating management, the unit’s reporting supervisor, the Vice President for Administration, the University Chief Accountant, and other appropriate members of senior University management. This report is primarily for internal University management use. The approval of the Internal Audit Director is required for release of the report outside of the University.

Client response
The client has the opportunity to respond to the audit findings prior to issuance of the final report which can be included or attached to our final report. However, if the client decides to respond after we issue the report, the first page of the final report is a letter requesting the client’s written response to the report recommendations.

In the response, the client should explain how report findings will be resolved and include an implementation timetable. In some cases, managers may choose to respond with a decision not to implement an audit recommendation and to accept the risks associated with an audit finding. The client should copy the response to all recipients of the final report if s/he decides not to have their response included/attached to Internal Audit’s final report.

Client comments
Finally, as part of Internal Audit’s self-evaluation program, we ask clients to comment on Internal Audit’s performance. This feedback has proven to be very beneficial to us, and we have made changes in our procedures as a result of clients’ suggestions.
Audit follow-up
Within approximately one year of the final report, Internal Audit will perform a follow-up review to verify the resolution of the report findings.

Follow-up review
The client response letter is reviewed and the actions taken to resolve the audit report findings may be tested to ensure that the desired results were achieved. All unresolved findings will be discussed in the follow-up report.

Follow-up report
The review will conclude with a follow-up report which lists the actions taken by the client to resolve the original report findings. Unresolved findings will also appear in the follow-up report and will include a brief description of the finding, the original audit recommendation, the client response, the current condition, and the continued exposure to Indiana University. A discussion draft of each report with unresolved findings is circulated to the client before the report is issued. The follow-up review results will be circulated to the original report recipients and other University officials as deemed appropriate.

Internal audit annual report to the board
In addition to the distribution discussed earlier, the contents of the audit report, client response, and follow-up report may also communicated to the Audit Committee of the Board as part of the Internal Audit Annual Report.

The process: a collaborative effort
As pointed out, during each stage in the audit process-preliminary review, field work, audit reports, and follow-up-clients have the opportunity to participate. There is no doubt that the process works best when client management and Internal Audit have a solid working relationship based on clear and continuing communication.

Many clients extend this working relationship beyond the particular audit. Once the audit department has worked with management on a project, we have an understanding of the unique characteristics of your unit’s operations. As a result, we can help evaluate the feasibility of making further changes or modifications in your operations.

1.9 Auditing Documentation
The word “document” is used to refer to a written or printed paper that bears the original, official, or legal form of something and can be used to furnish decisive evidence or information. “Documentation” refers to the act or an instance of the supplying of documents or supporting references or records. According to Auditing and Assurance Standard 3 (AAS 3) issued by the Institute of Chartered Accountants of India “Documentation” refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of the audit.

Review
In contrast, a review provides a negative assurance report giving only a moderate level of assurance on the reliability of the financial information. The report essentially states that nothing has come to the reviewer’s attention to indicate that the financial information is not presented fairly in accordance relevant accounting standards and principles. Review engagements are designed as a limited review of financial statements; therefore the risk of mistakes, omissions or incorrect disclosures is considerably greater than with an audit.

Peer review
The dictionary meaning of the word “Peer” is “A person who has equal standing with another or others”. The term “Review” is defined as “subject to a formal inspection or appraisal and reassessment of the matter in question”. Thus, peer review for chartered accountants would mean evaluation of a colleague’s work professionally. Peer review applies only to practicing Chartered Accountants as Audit and assurance work can be performed by practicing Chartered Accountants only.

Peer review is conducted with an idea to suggest improvements in the reporting services provided unlike auditing and investigation which are conducted with a focus to comment on the truthfulness of the financial and accounting records.
Other assurance services
The other types of assurance services usually provided by an auditor which are not related to Audit include due diligence report.

1.9.1 Form and Content of Documentation
The form and content of audit documentation should be designed to meet the circumstances of the particular audit. The information contained in audit documentation constitutes the principal record of the work that the auditors have performed in accordance with standards and the conclusions that the auditors have reached. The quantity, type, and content of audit documentation are a matter of the auditors’ professional judgment. The Audit documentation therefore is not restricted to being only on papers, but can also be on electronic media.

Generally the factors that determine the form and content of documentations for a particular engagement are:

- The nature of the engagement
- The nature of the business activity of the client
- The status of the client
- Reporting format
- Relevant legislations applicable to the client
- Records maintained by the client
- Internal controls in operation
- Quality of audit assistants engaged in the particular assignment and the need to direct and supervise their work

1.9.2 Permanent and Current Audit Files
In the case of recurring audits, some working paper files may be classified as permanent audit files, which are updated currently with information of continuing importance to succeeding audits. In contrast current audit files contain information relating primarily to the audit of a single period.

A permanent audit file normally includes:

- Copy of initial appointment letter if the engagement is of recurring nature
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor
- NOC from previous auditor
- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions. i.e.,
  - In case of partnerships: Partnership deed
  - In case of trusts: Trust deed
  - In case of societies: Certificate of registration/ Rules and Bye-laws
- Organisational structure of the client
- List of governing body including Name, Address and contact details. For Instance, the List of Directors in case of a company, List of partners in a partnership and list of Trustees in a Trust.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years
- Analysis of significant ratios and trends
- Copies of management letters issued by the auditor, if any
- Notes regarding significant accounting policies
• Significant audit observations of earlier years
• Assessment of risks and risk management
• Major policies related to Purchases and Sales
• Details of sister concerns
• Details of Bankers, Registrars, Lawyers etc
• Systems and Data Security policies
• Business Continuity Plans

The current file normally includes:
• Correspondence relating to acceptance of annual reappointment.
• Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.
• Evidence of the planning process of the audit and audit programme.
• Analysis of transactions and balances.
• A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
• Evidence that the work performed by assistants was supervised and reviewed.
• Copies of communications with other auditors, experts and other third parties.
• Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
• Letters of representation or confirmation received from the client.
• Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor’s procedures were resolved or treated.
• Copies of the financial information being reported on and the related audit reports.
• Audit review points and highlight.
• Major weakness in Internal control.

1.9.3 Need for Audit Documentation

Documents believed to be related to Enron were destroyed, focusing the attention of regulators and lawmakers on the contents and retention of audit documentation. The audit working papers (current and permanent) for a client audit engagement should be sufficiently detailed to enable another appropriately experienced and competent auditor who is not familiar with the client to obtain an overall understanding of the engagement.

The need for working papers can be listed as follows:
• They aid in the planning and performance of the audit.
• They aid in the supervision and review of the audit work and to review the quality of work performed, in accordance with AAS 17 “Quality Control for Audit Work”.
• They provide evidence of the audit work performed to support the auditor’s opinion.
• They document clearly and logically the schedule, results of test, etc.
• The working papers should evidence compliance with technical standards.
• They document that Internal control has been appropriately studied and evaluated.
• They document that the evidence obtained and procedures performed afford a reasonable basis for an opinion.
• They retain a record of matters of continuing significance to future audits of the entity.
• They enable an experienced auditor to conduct quality control reviews in accordance with Statement on Peer Review issued by the Institute of Chartered Accountants of India.
• The process of preparing sufficient audit documentation contributes to the quality of an audit.
• They fulfil the need to document oral discussions of significant matters and communicate to those charged with governance, as discussed in AAS 27, “Communication of Audit Matters with those Charged with Governance.

Guidance to staff on audit documentation
Proper guidance should be given to staff regarding the following:
• Filing/keeping of working papers.
• Checklist of documents to be obtained and maintained.
• Indexing of documents/ working papers.
• Proper numbering/ sequencing of working papers.
• Summarising of overall findings.
• Writing of queries.
• Discussing with seniors on matters of importance.
• Disposing of Query - at staff level/ senior level/ partner level.
• Importance of the working papers to be signed, dated and approved by relevant level of audit staff with sufficient cross reference.
• Importance of depicting the client’s name, file number, accounting period, subject of working paper and reference of working paper with current or permanent file.

1.9.4 Retention of Working Papers/ Documents
The auditor should retain the working papers for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention. Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

Requests for access to working papers
• AAS 1, Basic Principles Governing An Audit, states in para 6, “The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.”
• (AAS) 3, Documentation (Paragraph 13), states, “Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client.” AAS 3 further requires inter alia, that the “auditor should adopt reasonable procedures for custody and confidentiality of his working papers.”
• Part I of the Second Schedule to the Chartered Accountants Act, 1949 provides that “A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he –
• “Discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force.”
• Requests may be received by the members of the Institute, who have/had been performing the duties as the auditors of an enterprise, to provide access to their audit working papers from the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.
Under the circumstances ICAI has clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term ‘auditor’ includes ‘internal auditor’.

The client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client.

1.9.5 Tips for Auditors on Documentation / Working Papers

General guidelines for the preparation of working papers are as follows:

- Clarity and Understanding: As a preparer of audit documentation, step back and read your work objectively. Would it be clear to another auditor? Working papers should be clear and understandable without supplementary oral explanations. With the information the working papers reveal, a reviewer should be able to readily determine their purpose, the nature and scope of the work done and the preparer’s conclusions.

- Completeness and Accuracy: As a reviewer of documentation, if you have to ask the audit staff basic questions about the audit, the documentation probably does not really serve the purpose. Work papers should be complete, accurate, and support observations, testing, conclusions, and recommendations. They should also show the nature and scope of the work performed.

- Pertinence: Limit the Information in working papers to matters that are important and necessary to support the objectives and scope established for the assignment.

- Logical Arrangement: File the Working papers in a logical order.

- Legibility and Neatness: Be neat in your work. Working papers should be legible and as neat as practical. Sloppy work papers may lose their worth as evidence. Crowding and writing between lines should be avoided by anticipating space needs and arranging the work papers before writing.

- Safety: Keep your work papers safe and retrievable.

- Initial and Date: Put your initials and date on every working paper.

- Summary of conclusions: Summarise the results of work performed and identify the overall significance of any weaknesses or exceptions found.

1.10 Internal Control System

Internal control is a company’s system, defined and implemented under its responsibility. It comprises a set of resources, patterns of conduct, procedures and actions adapted to the individual characteristics of each company which:

- contributes to the control over its activities, to the efficiency of its operations and to the efficient utilisation of its resources

- enables it to take into consideration, in an appropriate manner, all major risks, be they operational, financial or compliance

The system more particularly designed to ensure that:

- Laws and regulations are complied with the instructions and directional guidelines fixed by Executive Management or the Management Board are applied.

- The company’s internal processes are functioning correctly, particularly those implicating the security of its assets financial information is reliable.
Internal control is therefore not limited to a set of procedures, nor simply to accounting and financial processes. Nor does it embrace all of the initiatives taken by the executive bodies or by management, such as defining company strategy, fixing objectives, management decisions, dealing with the risks or monitoring performance.

1.10.1 Scope of Internal Control

It is the responsibility of every company to design an internal control system which is suitably adapted to their situation. In the case of a group, the parent company ensures that internal control systems exist within its subsidiaries. These systems should be adapted in line with their own individual characteristics and to the relationship that exists between the parent company and the subsidiaries. In situations where a parent company has a substantial holding interest, over which it has significant influence, that parent should take care to assess the possibility of acquainting itself with and examining the measures taken by its affiliate, in terms of internal control.

1.10.2 Internal Control System Components

The principal directional guidelines in terms of internal control are determined in line with the company’s objectives. These objectives must be applicable to the various units of the entity and clearly communicated to staff so that they can understand and adhere to the organisation’s risk and control policy. Internal control will be that much more relevant if it is built on rules of conduct and integrity upheld by the governance bodies and communicated to all staff. In no way can it be reduced to a purely formal system with serious breaches in business ethics taking place on the sidelines. It is true that the internal control system can not, in itself, prevent company staff from committing fraud, contravening legal or regulatory provisions, or communicating misleading information outside the company about its situation.

The internal control system consists of five closely related components. Although these components apply to all companies, the way they are implemented will vary depending on the size and the business sector of companies.

These five components are as follows:

- An organisation comprising a clear definition of responsibilities, with suitable resources and competencies and supported by appropriate information systems, procedures or operating methods, tools and practices The implementation of an internal control system must be based on fundamental principles but also on:
  - a suitable organisation which provides the framework in which the activities implicit in meeting the objectives are planned, carried out, followed up and controlled
  - clearly defined responsibilities and powers which are granted to the right people depending on the company’s objectives. They can be formalised and communicated by means of task or job descriptions, operating and functional line organisation charts, delegation of powers, and should respect the principle of the segregation of duties
  - a human resource management policy which should enable people to be recruited with the appropriate knowledge and competencies required to carry out their responsibility and to meet the current and future objectives of the company
  - information systems which are adapted to the current objectives of the organisation and designed to be able to respond to its future objectives. The IT systems on which these information systems depend must be effectively protected, both in terms of physical and logical security, thereby ensuring that there is no loss of the information stored. Their operational continuity is guaranteed by back-up procedures. The information on the analyses, the programming and processing functionalities must be documented.
  - operating procedures or methods which specify the way in which an action or process should be carried out (objectives to be achieved within a given time-frame, definitions of functions and operating/reporting lines, policy framework, decision-making and assessment tools, control frequency, person responsible for the control, …), regardless of their format and type of support aid.
  - tools or work facilities (office automation, IT) which are adapted to everyone’s needs and which every user should be suitably trained in
  - practices which are commonly accepted within the company
• The in-house dissemination of relevant and reliable information, the awareness of which enables everyone to exercise their responsibilities:
- The company should employ processes which ensure that all relevant and reliable information is communicated in a timely manner to all relevant players within the company, thereby enabling them to exercise their responsibilities.

• A system for identifying and analysing the main identifiable risks in relation to the company’s objectives and for ensuring that procedures exist for managing those risks.

Given the ever-changing environment and regulatory context, companies implement methods to identify, analyse and manage the risks, both internal and external, with which they may be confronted and which could reduce the likelihood of them meeting their business objectives.

Risk identification
The company identifies the main identifiable risks, both internal and external, which could have an impact on the likelihood of it meeting the objectives it has fixed for itself. This identification process, which is on-going, should cover those risks which could have a significant impact on its situation.

Risk analysis
This involves taking into consideration the likelihood of the risks occurring and their potential seriousness, as well as considering the environment and existing control measures. These different elements are not static, on the contrary, they form part of the risk management process.

Risk management procedures
Executive Management or the Management Board, supported by a risk management function, if there is one, should define risk management procedures.

• Control activities proportionate to the implications of each individual process and designed to ensure that the appropriate measures are taken in order to control the risks that could affect the company’s ability to achieve its objectives.

• Control activities can be found everywhere in the organisation, at every level, and in every function, be they controls focusing on prevention or detection, manual or computerised controls, or controls by virtue of the reporting structure. In any event, control activities are determined in the light of the nature of the objectives with which they are associated and are proportionate to the implications of each process. In this context, particular attention should be paid to the controls over the processes involved in designing and running information systems.

• On-going monitoring of the internal control system together with a regular review of the way it is operating.
  - As for any system, the internal control system requires on-going monitoring. The aim is to check its relevance and appropriateness to the company’s objectives. Implemented by management and steered by the Executive Management or the Management Board, this monitoring principally comprises the analysis of the main incidents that have been recorded, the result of the controls performed, together with the work carried out by the internal audit team, when there is one. This monitoring also takes into consideration the observations made by the statutory auditors and by regulatory oversight bodies.
  - Another useful complement to the monitoring tools can be to keep an active watch on internal control best practices.
  - Monitoring, together with the best practices watch, culminate, where required, in the implementation of corrective actions and adjustments to the internal control system.
  - Executive Management or the Management Board should assess the parameters for informing the Board of the main results of the monitoring and reviews thus performed.
1.10.3 Limitations in Internal Control

However well conceived and applied the internal control system might be, it cannot provide an absolute guarantee that the company’s objectives will be met. The likelihood of meeting these objectives does not depend solely on the will of the company. There are in fact limitations which are inherent in any internal control system. These limitations are due to several factors, notably to the uncertainties in the outside world, to the exercise of people’s judgement or to problem areas that can arise as a result of human failure or of a simple error.

In addition, when implementing controls, it is important to bear in mind the cost / benefit relationship and not to develop internal control systems which are unnecessarily costly, even if it means accepting a certain degree of risk.
An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

Auditing is done by the auditor to find out whether the financial statements are prepared by business concerns to know the result of the business activity undertaken by them throughout the year.

The broad aim of audit is to safeguard the financial interests of the tax payer and to assist the Parliament/ State/ Union territory legislatures in exercising financial control over the executive.

Regularity audit consists mainly in checking that the payments have been duly authorised and are supported by proper vouchers in the prescribed form.

Financial audit is one that is conducted in order to ensure that the accounting and financial control systems are efficient and cooperating properly; and that financial transactions have been correctly authorised and accounted for.

In receipts audit, the function of audit department is to ensure that adequate regulations and procedures have been framed and are being observed by the revenue department, to secure an effective check on assessment, collection and proper allocation of revenue.

It has been accepted that Regularity audit/Propriety audit is essential for parliamentary control of expenditure.

The Auditing Practices Committee (re-christened as Auditing and Assurance Standards Board) was constituted in September, 1982 as one the important technical committees of the ICAI on the lines of the standard setting procedure prevalent abroad.

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations.

According to Auditing and Assurance standard 3 (AAS 3) issued by the Institute of Chartered Accountants of India “Documentation” refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of the audit.

References


Recommended Reading

Self Assessment

1. _______ consists mainly in checking that the payments have been duly authorised and are supported by proper vouchers in the prescribed form.
   a. Financial audit
   b. Regularity audit
   c. Receipt audit
   d. Performance audit

2. In which of the following, the function of audit department is to ensure that adequate regulations and procedures have been framed and are being observed by the revenue department, to secure an effective check on assessment, collection and proper allocation of revenue?
   a. Financial audit
   b. Regularity audit
   c. Receipt audit
   d. Performance audit

3. Financial audit and _______ generally involve scrutiny of individual transactions.
   a. Regularity audit
   b. Accounts audit
   c. Performance audit
   d. Receipt audit

4. _______ seeks to find out whether the resources have been utilised efficiently by deploying them in an optimum manner.
   a. Financial audit
   b. Regularity audit
   c. Receipt audit
   d. Performance audit

5. Which of the following does not concern itself with the audit of administrative organisations and procedures and is different from administrative audit?
   a. Regularity audit
   b. Performance audit
   c. Financial audit
   d. Receipt audit

6. Which of the following statement is false?
   a. The utility of Performance audit can hardly be over-emphasised.
   b. An auditor plans and performs his audit recognising that he may encounter conditions or events during his examination that would lead him to question whether fraud or error exists.
   c. The utility of Regularity audit can hardly be over-emphasised.
   d. The Board is also in the process of formulation Statement on Standard Auditing Practices on Auditor’s Report on Financial Statements.
7. Which of the following helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process?
   a. Regularity audit
   b. Performance audit
   c. Internal audit
   d. Financial audit

8. In which phase of the audit process, the auditor gathers relevant information about the unit in order to obtain a general overview of operations?
   a. Initial meeting
   b. Preliminary survey
   c. Audit program
   d. Fieldwork

9. Which of the following is conducted with an idea to suggest improvements in the reporting services provided unlike auditing and investigation, which are conducted with a focus to comment on the truthfulness of the financial and accounting records?
   a. Financial auditing
   b. Internal audit
   c. Peer review
   d. Internal control system

10. The internal control system consists of _____ closely related components.
    a. two
    b. three
    c. four
    d. five
Chapter II
Auditing Techniques and Internal Audit Introduction

Aim
The aim of this chapter is to:
• introduce audit sampling
• explain audit sampling
• define internal control

Objectives
The objectives of this chapter are to:
• explain sampling risk and various aspects of it
• explicate internal control and auditor
• define test checking

Learning outcome
At the end of this chapter, you will be able to:
• distinguish between test checking and routing checking
• understand advantages and disadvantages of test checking
• identify the meaning of audit sample
2.1 Introduction
Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors.

If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the bank makes the loan on the basis of misleading financial statements and the borrower company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money.

2.2 Aspects of Verification
At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. While auditing in depth, the auditor reviews all the accounting and operational aspects of the transaction from the origin to the end. This enables him to have an overall view and evaluate the procedures through selected transactions.

A representative sample must be open and each item selected must be traced meticulously. A smaller number of transactions are checked at each successive stage with an in-depth test, on statistical grounds (based on probability theory) that the optimum sample size decreases as the Auditor’s “level of confidence” concerning the functioning of the system increases. Examination in depth reconstructs the audit trail and reveals more about the functioning (or malfunctioning) of the client’s system in practice than the haphazard and mechanical approach to testing.

Consider an example, audit in depth of transactions relating to purchase of goods involves verification of the following:

- Purchase requisition: pie-printed, pre-numbered and authorised
- Invitation of quotations and analysis of the same
- Official purchase order, sequentially pre-numbered, authorised and placed with approved suppliers only
- Receipt of goods, together with delivery challan / advice note
- Admission of goods to stores after verification of quality, quantity, etc.
- Entry in stores records
- Receipt of supplier’s invoice and statement
- Approval of purchase invoice regarding compliance for specification, quantity and quality
- Entries in purchases day book
- Purchase ledger control account and postings to purchase ledger
- Payment of cheque in settlement of invoice after availing discounts; if any
- Entry for payment in cash / bank book
- Posting from cash book to ledger and control accounts

2.3 Test Checking
Test Checking means to select and examine a representative sample from a large number of similar items. Test Checking is an accepted auditing procedure wherein instead of checking all transactions, only a part of it is checked in detail to form an opinion on the whole.
2.3.1 Features of Test Checking
Test checking consists of selecting and checking a proportion of transactions selected by the auditor. The salient features of test checking are as follows:

- **Scientific**: It is a mathematical truth that a scientifically selected sample would reveal the features and characteristics of the population. The statistical theory of sampling is based on a scientific law. Hence, it can be relied upon to a greater extent than any arbitrary technique which lacks basis and acceptability.

- **Estimation process**: Test checking and sampling can never bring complete reliability; it cannot give accurate results. It is a process of estimation. What error is tolerable for a particular matter under examination is a matter of the individual’s judgment in that particular.

- **Coverage of material items**: Entries involving large amounts or relating to material accounts are seen exhaustively and other entries are picked up for verification from the remainder according to a certain plan. Sometimes entries are checked for a few specified months exhaustively and the rest go unchecked.

- **Full coverage over a time period**: Test check is normally planned in such a way that the audit programs for 3 to 5 years cover all types of transactions in case of a medium or large sized company. Thus, if in one year the months of January, June and December are checked; April, July and September may be checked in the second year and so on.

- **Surprise element**: The staff and management of the auditing company should not be able to anticipate the pattern of test checking; otherwise they will predict the areas and periods to be covered in any one year and will be careful regarding the same.

- **Flexibility**: If test checking becomes routine, predictable and mechanical, it loses its value. Hence, the auditor should keep changing the methods of test checking at reasonably frequent intervals.

- **Judgment based**: The extent of test checking would primarily depend on the auditor’s judgment of a particular situation. This judgment in turn depends on the previous experience of the auditor, current developments and the efficacy of Internal Control System.

2.3.2 Factors to be Considered
The factors to be considered for deciding upon the extent of checking on a sampling plan are:

- **Size of the organisation under audit**
- **State and efficacy of the internal control**
- **Adequacy and reliability of books and records**
- **Tolerable error range**
- **Degree of the desired confidence**

2.3.3 Usage of Test Check
Test checks can be adopted in the following cases:

- **Volume of transactions**: In case of big concerns where number of transactions is quite large.
- **Time factor**: Where the auditor has very little time at his disposal to check all the transactions of a medium or large sized concern.
- **Identical transactions**: When there are a number of transactions of identical and homogeneous nature.
- **Internal control**: When there exists a satisfactory internal control system, manual and / or computerised.

2.3.4 Advantages of Test Checking
There are many advantages of test checking, some of them are listed below:

- **Audit objective**: The auditor is required to form an opinion on the financial statements. Even after 100% checking, he may not derive absolute satisfaction. Hence, proper and careful test checking serves the audit objective in obtaining reasonable audit assurance.

- **Expertise**: Application of test check principles involves the application of mind and intelligent judgment. It enables the auditor to use his expertise effectively.
• Exception principle: Test Checking adopts the principle of exception in control. If certain aspects of internal control do not create suspicion, there is no need to verify all those transactions exhaustively.

• Scientific assessment of risk: The auditor assesses the risk of material misstatements in the financial statements in a scientific manner by drawing suitable samples and studying the same in detail.

• Saving in time: As fewer transactions are verified, time is saved to a great extent. This, in turn, enables completion of all the audits / verification procedures in time.

• Reduction in work: Volume of work is reduced by test checking methods. Audit processes are not carried out mechanically on all transactions.

2.3.5 Disadvantages of Test Checking
The disadvantages of test checking with some precautions are given below:

• Naive and biased: The extent to which test checking can be resorted to is a matter of auditor’s personal assessment. It does not ensure selection of representative samples of adequate size and offers opportunities for bias to enter into selection process.

• Unauthentic: Test checking lacks authenticity, precision and an acceptable basis. It does not give the auditor an idea about the degree of reliability that can be placed on the findings for application to the whole set of entries.

• Higher risk: Runs the risk that some of the material error may not be discovered and some of the important areas may go unaudited. Sometimes, it may increase the level of inherent audit risk.

• Unscientific: It involves lot of arbitrariness on the part of the auditor in determining and selecting the number of transactions. Therefore, the approach cannot be considered as a scientific one.

• Difference in activity levels: Where activity levels vary in a year, e.g., a few months of peak production and sales seasons, the auditor cannot draw reasonable conclusions about the transactions of the whole year merely by checking transactions of a few specified months.

• Lack of surprise element: If the surprise element is absent, the client may predict the pattern of checking.

2.4 Test Checking Vs Routing Checking
We will see the differences between test checking and routing checking according to various features:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Test checking</th>
<th>Routine checking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meaning</td>
<td>Test checking is an accepted auditing procedure wherein only a part of its transactions is checked to form an opinion instead of checking the transactions.</td>
<td>Routine checking is the detailed checking of all transactional aspects such as casts, sub – casts, carry-forwards, extensions and calculations etc. in subsidiary books, checking of posting into the ledgers, casting of ledger accounts and extraction of their balances etc.</td>
</tr>
<tr>
<td>Objectives</td>
<td>To obtain a reasonable level of satisfaction about all transactions but verifying a few representative transactions called “sample”.</td>
<td>• To verify the arithmetical accuracy of the entries</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To verify the accuracy of posting to ledgers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To check that the ledger accounts have been correctly balanced</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To ensure that no figures are altered after checking</td>
</tr>
<tr>
<td>Advantages</td>
<td>• Saving in time</td>
<td>• Checking of posting and ledgers.</td>
</tr>
<tr>
<td></td>
<td>• Proper and careful test checking is helpful &amp; serves the audit objective</td>
<td>• Arithmetical accuracy can be checked.</td>
</tr>
<tr>
<td></td>
<td>• Volume of work is reduced</td>
<td>• Trial balance tallying is facilitated.</td>
</tr>
<tr>
<td></td>
<td>• Time available for other audits</td>
<td>• Easy detection of errors and frauds.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Delegation of audit work to junior staff</td>
</tr>
</tbody>
</table>
Disadvantages
- Client staff may become careless.
- Some errors and frauds may go undetected.
- All items and transactions are not checked.
- An element of doubt and risk is present in the auditor’s opinion.
- Is a highly mechanical process.
- Monotonous activity may lead to boredom.
- Major items of frauds and high level intricacies and complexities may not be revealed.
- Compensating Errors and Errors of Principle will not come to light.

<table>
<thead>
<tr>
<th>Table 2.1 Difference between test checking and routing checking</th>
</tr>
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</table>

2.5 Audit Sampling
Establishing standards on the design and selection of an audit sample and the evaluation of the sample results is the job of Auditing and Assurance Standard (AAS). This AAS is applicable to both the statistical sampling methods equally. If both the methods are applied properly they can provide sufficient appropriate audit evidences. While using statistical or non-statistical sampling methods, designing and selection of an audit sample should be done by an auditor, and the auditor should perform audit procedures thereon, and evaluate sample results so as to provide sufficient appropriate audit evidence.

“Audit sampling” means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population. Certain testing procedures do not come within the definition of sampling. Tests performed on 100% of the items within a population do not involve sampling. Also applying audit procedures to all items within a population which have a particular characteristic does not qualify as audit sampling with respect to the population examined, for example, all items over a certain amount. Likewise it is not with regard to the population completely, because the items were not selected from the total population on a basis that was expected to be representative. Such items can be the reason to imply some characteristic of the remaining portion of the population but would not necessarily be the basis for a valid conclusion about the remaining portion of the population.

2.5.1 Factors in Determining Sample Size and Sampling Risk
When determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. Sampling risk arises from the possibility that the auditor’s conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. The auditor is faced with sampling risk in both tests of control and substantive procedure as follows:

Tests of control
Tests of control consist of two types of risks, both are explained below.
- Risk of under reliance: The risk that, although the sample result does not support the auditor’s assessment of control risk, the actual compliance rate would support such an assessment.
- Risk of over reliance: The risk that, although the sample result supports the auditor’s assessment of control risk, the actual compliance rate would not support such as an assessment.

Substantive procedures
Substantive procedures are also broken down into two risks. They are explained below:
- Risk of incorrect rejection: The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.
- Risk of incorrect acceptance: The risk that, although the sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection. Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.
Tolerable error
Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditor’s judgment about materiality. The smaller the tolerable error, the greater the sample size will need to be.

In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that the auditor would be willing to accept, based on the preliminary assessment of control risk. In substantive procedures, the tolerable error is the maximum monetary error in an account balance or class of transactions that the auditor would be willing to accept so that when the results of all audit procedures are considered, the auditor is able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

Expected error
If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free. In determining the expected error in a population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity’s procedures, and evidence available from other procedures.

2.6 Selection of the Sample
The auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected. While there are a number of selection methods, three methods commonly used are:

- Random selection, which ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.

- Systematic selection involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every Rs 1,000 increase in the cumulative value of the population). When using systematic selection, the auditor would need to determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch’s sales occur only as every 100th item and the sampling interval selected is 50; the result would be that the auditor would have selected all, or none, of the sales of that particular branch.

- Haphazard selection, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units. When the auditor uses this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

2.6.1 Evaluation of Sample Results
Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:

- analyse any errors detected in the sample
- project the errors found in the sample to the population; and
- reassess the sampling risk
2.6.2 Analysis of Errors in the Sample
In analysing the errors detected in the sample, the auditor will first need to determine that an item in question is in fact an error. In designing the sample, the auditor will have defined those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of accounts receivable, a mis-posting between customer accounts does not affect the total accounts receivable. Therefore, it may be appropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

When the expected audit evidence regarding a specific sample item cannot be obtained, the auditor may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive account receivable confirmation has been equated and no reply was received, the auditor may be able to obtain sufficient appropriate suit evidence that the receivable is valid by reviewing subsequent payments from the customer. If the auditor does not, or is unable to, perform satisfactory alternative procedures if the procedures performed do not enable the auditor to obtain sufficient appropriate audit evidence, the item would be treated as an error.

The auditor would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit. In analysing the errors discovered, the auditor may observe that many have a common feature, for example, type of transaction, location, product line, or period of time. In such circumstances, the auditor may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. The auditor would then perform a separate analysis based on the items examined for each sub-population.

2.6.3 Projection of Errors
The auditor projects the error results of the sample to the population from which the sample was selected. There are several acceptable methods of projecting error results. However, in all the cases, the method of projection will need to be consistent with the method used to select the sampling unit. When projecting error results, the auditor needs to keep in mind the qualitative aspects of the errors found. When the population has been divided into subpopulation, the projection of errors is done separately for each subpopulation and the results are combined.

2.6.4 Reassessing Sampling Risk
The auditor needs to consider whether errors in the population might exceed the tolerable error. To accomplish this, the auditor compares the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, the auditor reassesses the sampling risk and if that risk is unacceptable, would consider extending the audit procedure or performing alternative audit procedures.

2.7 Internal Control
Internal control is another important area of auditing. Internal control refers to a number of checks and controls exercised in a business to ensure its efficient and economic working. In this chapter you will learn the meaning and objectives of internal control and internal check. You will also learn various system of internal check and generally understand audit in respect of computer environment.

2.7.1 Meaning and Definition of Internal Control
Internal control is an important tool of management. It assists the management in the performance of its various functions. It means the built in cross-checks in the system supplemented with proper supervision and internal audit carried out by the staff appointed by the organisation. These days business has become more complex both in nature and size and the management finds it difficult to get correct information about the various aspects of the business. Internal control assures the management that the information supplied to it is reliable and accurate. The internal controls are exercised to ensure the accuracy and the reliability of accounting data and other records, to identify weaker areas of operation and to improve them to increase operational efficiency of the business, to safeguard its assets and to ensure orderly conduct of business.
The American Institute of Public Accountants has defined internal control as the plan of organisation and all the co-ordinate methods, and measures adopted within a business to safeguards its assets, check the accuracy and the reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies. A system of internal control extends beyond those matters which relate directly to the function of the accounting and financial departments. The Institute of Chartered Accountants of England and Wales defines internal control as “internal control means not only internal check or internal audit, but the whole system of control financial and otherwise, established by management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible accuracy and reliability of its records”.

If we analyse the above definitions it would be evident that internal control is a broad term with a wide coverage. It consists of a number of checks and controls which are exercised in a business to ensure its efficient and economic working. Thus internal control involves sort vigilance and directions over important matters like budget and finance, purchase and sales and internal administration by the management. Every business enterprise is expected to devise a suitable system of internal control in order to carry on the business in an efficient and orderly manner. These controls are accounting control, budgetary control, statistical analysis and internal checks and internal audit. In simple words, it means number of checks and controls over the various activities of a business. Generally, a system of internal control will include all those measures which assist a business enterprise to fulfil the following objectives:

- To minimise, if not completely eliminate, wastage and inefficiencies in business operations and to safeguard the assets of the business.
- To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.
- To measure how far the policies of the management are being implemented, and
- To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.

2.7.2 Forms of Internal Control

Various forms of internal control help in ensuring correct and reliable records of transactions and operational efficiencies. Let us discuss them in detail.

**Accounting control**

It ensures correct and reliable records of transactions in conformity with normally accepted accounting principles. Such controls comprise primarily the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and liabilities of financial records. Accounting financial controls include budgetary control, standard cost control, self balancing ledger, bank reconciliation and internal checks and internal auditing. Accounting controls deal with the process of recording of transactions, safeguarding the assets and adherence to prescribed managerial policies.

**Administrative control**

The scope of this control is very wide. They also include accounting controls. Such controls comprise of the plan of organisation that are concerned mainly with operational efficiencies. In short they may include anything from plan of organisation to procedures, record keeping, distribution of authority and the process of decision making. They include controls viz. time and motion studies, quality control through inspection, statistical analysis and performance evaluation etc. An auditor should make a careful review of accounting controls as they have a direct bearing on the reliability of the financial statements. He is primarily concerned with the accounting controls.

**Internal control and auditor**

The position of the auditor regarding internal control has been stated in the statement of auditing practices issued by the Institute of Chartered Accountants of India which says “the duty of safeguarding the assets of a company is primarily that of management and the auditor is entitled to rely upon the safeguard and internal controls instituted by the management, although he will take into account the deficiencies, he may note therein while drafting his audit program”. It clearly means that an auditor is concerned only with the evaluation of internal control to know its strength and weaknesses. In case he finds that the internal control system is inadequate, he should then plan to carry out detailed examination of those areas where the system is weak. It is therefore necessary for the auditor to acquaint himself fully with the internal control in force and their actual operation. It will help him in the formulation of his audit program. He may also bring the shortcomings of the internal control system to the notice of the management.
Requisites of a good internal control system

The following are the essential requisites of a good internal control system:

- A well developed plan of organisation with proper delegation of functional responsibilities should be revised. No internal control system can be effective without such plan of organisation.

- A scientific system of authorisation and record procedure should be developed with a view to provide proper control over assets, liabilities, revenue and expenses of the organisation. It should be developed in such a fashion as to ensure that:
  - assets are under proper custody and they are not improperly applied
  - expenditures are incurred on getting proper authorisation
  - revenues received are duly accounted for

- A system of healthy practices and traditions should be developed with a view to discharge the duties and functions of the various departments of the organisation smoothly.

- Since internal control system is to be exercised by the personnel employed in the organisation, there should be a team of people with sound character and integrity who are properly trained and capable of discharging their responsibilities.

- Constant managerial supervision and periodical review of the system should be introduced with a view to make the system more efficient and effective.

2.8 Internal Audit

Internal audit is described as the verification of the operations within the business by a specially assigned staff. It is an important tool of management to evaluate the correctness of records on a continuous basis in an organisation. The term internal audit has been defined as “An independent appraisal of activity” within an organisation for review of operations as a basis of service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls. According to Howard F. Stettler, “Internal auditing is an independent appraisal activity within an organisation for the review of operations as a service to management.”

The overall objective of internal auditing, therefore, is to assist the management in the effective discharge of their responsibilities by furnishing them with objective analysis, appraisals, recommendations and pertinent comments concerning the activities reviewed. In short internal audit assures the management that the system of internal check and other types of controls are effective in design and operation. Thus, internal audit is a thorough examination of the accounting transactions to ensure that:

- The transactions are properly recorded.
- The accounts are maintained systematically.
- There is no possibility for manipulation of accounts or misappropriation of property of the business.

In modern times, an internal auditor carries a new task. The traditional function of checking the arithmetical correctness of the accounts with the help of vouchers and documents and verification of few items such as stock, cash and fixed assets is not sufficient. The duty of internal auditor now is to chart the procedure, examine the efficiency and work on programs of improvement of assessing the effectiveness of controls. He is expected to plan and arrange his task for effective functioning, set clear objectives of his own section, phase his objectives, gain the confidence of the management and demonstrate the value of his functions in areas of performance.

The internal audit is carried out generally in the same manner as is followed for a professional audit. However, it varies in form from enterprise to enterprise according to its size and specific needs. It is installed in large organisation and is carried out by the salaried staffs that are qualified to conduct professional audit. Being the employee of the organisation he has to ensure that there is no waste in the organisation. Internal auditor has to follow the provisions of law, standard auditing practices and procedure prescribed for professional auditors and by the professional bodies controlling the audit system in the country. At the same time internal auditor must be aware of the policies and programs of the enterprise he should be professionally competent to carry out a detailed examination of the working of the business. Equipped with professional expertise and knowledge of the business, he will be in a better position to make the internal audit system more effective.
2.8.1 Objectives of Internal Audit

The main objectives of internal audit are as follows:

- To verify the correctness and authenticity of the financial records and statistical records presented to the management.
- To ensure that the standard accounting practices are strictly followed in the organisation.
- To facilitate early detection of errors and frauds.
- To ensure that all the transactions have been carried out under a proper authority and by persons authorised for the same in the business.
- To review the system of internal checks from time to time to advice the management on improvement of the system and to undertake special investigation for the management.
- To confirm that the liabilities have been incurred by the organisation for legitimate activities.

Thus, efficiency of internal audit depends on the efficiency of the staff employed for the purpose; internal audit can be effective only if the internal auditor is given wider authority to investigate the transactions not only from financial angles but also from other organisational activities. Internal auditor should report directly to the top management. He must operate independently of the accounting and other staff. He must be given an independent status as an important functionary and a part of the management.

2.8.2 Internal Audit v/s Statutory Audit

Internal audit helps the statutory audit to a large extent. Both the internal auditor and the statutory auditor have a common interest as far as authenticity of the accounts is concerned. However, soundness of internal audit relieves the statutory auditor from detailed checking. The internal auditor reviews the operations and performs such functions as evaluation, compliance, verification and ensures that policies, procedures, rules and other type of controls of the business are carried out efficiently.

He is helpful to statutory auditor in the matter of examination of books of accounts. Generally, the statutory auditor accepts some of the detailed checking made by the internal auditor. However, the area of cooperation between internal auditor and statutory auditor is somewhat limited as the statutory auditor has a responsibility under law to various authorities, while the internal auditor is responsible only to the management. The statutory auditor has to carry out his duties in accordance with standard accounting and auditing practices and provisions of law which govern the organisation. Before accepting the checking of accounts and other documents carried out by internal auditor, the statutory auditor must undertake such test checks necessary to find out the effectiveness of internal audit.

Both internal auditor and statutory auditor carry out examination of records and documents and make physical and other verifications. Despite these similarities there are differences in the status, responsibilities, approach and scope of work of internal auditor and statutory auditor.
2.8.3 Differences Between Internal Audit and Statutory Audit

The following are the points of differences between internal audit and statutory audit:

<table>
<thead>
<tr>
<th>Internal Audit</th>
<th>Statutory Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal audit is the arrangement within the organisation to verify on continuous basis the correctness and truthfulness of the transactions by the salaried staff.</td>
<td>Statutory audit is the examination of the books of accounts of the business by an external auditor and to report that the profit and loss account and balance sheet are drawn according to provisions of law and the financial statements reveal the true and fair view of the results of operations and financial state of affairs of the business.</td>
</tr>
<tr>
<td>Internal audit is not compulsory.</td>
<td>Statutory audit is compulsory in case of business houses incorporated under the Companies Act and other acts.</td>
</tr>
<tr>
<td>Internal audit is carried out by the staff appointed by the business enterprises. It is not necessary that the internal audit staff should possess the qualification prescribed for professional auditor.</td>
<td>Statutory audit can be carried out only by those who are qualified for appointment as per the provision of the Companies Act and other acts.</td>
</tr>
<tr>
<td>Being an employee of the organisation internal auditor is answerable to the management. His duties, responsibilities etc. regarding audit work are determined by the management. The management can increase the powers and authority of the internal auditor. Similarly it can also curtail his powers.</td>
<td>The rights, duties, responsibilities and liabilities of auditors are governed by the provisions of law. The auditor is independent of management.</td>
</tr>
<tr>
<td>The internal auditor points out irregularities in the procedural aspects and suggests ways and means to rectify the same. He assures that the financial operations and other types of control in force are carried out in conformity with the accounting systems.</td>
<td>The statutory auditor is concerned with the legality and validity of the transactions of business. His audit work is based on the financial statement prepared by the business.</td>
</tr>
</tbody>
</table>

Table 2.2 Differences between internal audit and statutory audit

2.9 Internal Check

Internal check is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.

Spicer and Pegler have defined a system of internal check as “An arrangement of staff duties whereby no one person is allowed to carry through and record every aspect of a transaction such that without collusion between two or more persons fraud is prevented and at the same time possibilities of errors are reduced to a minimum”. De Paula has defined internal check as “A continuous internal audit carried on by the staff itself by means of which the work of each individual is independently checked by other member of the staff.”

Thus, under internal check system the staff duties are so arranged that no one person is allowed to record every aspect of the transactions and the entire work is distributed among the various members of the staff in such a manner that the work of one person is automatically checked by others.
The essential elements of internal check are as follows:

- Existence of checks on day to day transactions.
- The check is to be carried out continuously as a part of the routine system.
- The work is divided among the staff and each staff is assigned a specific task.
- The work of each staff though independent is complementary to the work of another.

The system of internal check is increasingly recognised by the auditor especially when the size of the concern is large. The existence of effective internal check system relieves the external auditor of detailed checking to a larger extent. The extent to which an external auditor can depend upon the system of internal check is based on the procedural tests applied by him to find out the effectiveness of the system. However, the auditor cannot be relieved of his responsibility if he was found guilty of negligence regardless of the fact that he had tested the internal check in existence in the organisation before he had accepted it as correct.

2.9.1 Objectives of Internal Check

The objectives of internal check are listed below:

- To reduce chance of fraud and errors that may be committed by any member of the staff and make it more difficult. If any fraud is to be committed two or more persons must collude together.
- To detect fraud and errors easily and correct them promptly.
- To exercise moral pressure among the members of the staff.
- To allocate duties and responsibilities of every person in such a way that he can be taken to task for any lapse on his part.
- To increase overall efficiency of the members of the staff by assigning duties based on the principle of division of labour.
- To have an accurate and reliable record of all business transactions.

2.9.2 Essentials of Good Internal Check System

Good internal check system is essential; various reasons for it to be essential are given below:

- No single staff shall have absolute control over recording of all the aspects of business transactions by himself.
- The same staff shall not be allowed to have access to all books of accounts as well as physical custody of the assets.
- Each member of the staff should be made responsible for a specific work.
- All officials and employees holding responsibility towards cash, securities or stock should be encouraged to proceed on annual leave to prevent the concealed fraud.
- The duties of the members of the staff should be changed from time to time.
- Attempt should be made to introduce mechanical devices to prevent mis-appropriation of cash.
- Each transaction should pass through a definite route and through several hands.
- All books, vouchers, documents should be classified and made available for easy reference.
- Proper record must be maintained of the incoming and outgoing of goods from the business premises.
- Self balancing ledger system should be introduced to make the system more efficient and effective.
- No undue importance should be given to any staff member and too much reliance on any staff member should be avoided.
- Division and allocation of duties among the staff members must provide for an automatic check by others.
2.9.3 Internal Check as Regard Cash Sales

Since chances of committing fraud in connection with cash sales are greater, it calls for devising an efficient and effective system of internal check. Cash sales may be affected in various ways like:

- Sale at counter
- Postal sales, i.e., sales under mail order
- Sales by representative and agents

The system of internal check to be followed in each case is discussed below.

- One salesman should be appointed to look after one counter independently and should be made responsible for sales affected in his counter.
- Each salesman must be issued with a separate cash memo book.

The cash memo book must be printed in different colours to identify different counters of the business.

- Each salesman must maintain a sales sheet. He should record therein the sales affected by him. The summary of cash sales affected by him must tally with the cash memos issued by him.
- Cash memos are to be issued with carbon copies.
- The salesman must not receive cash on the cash memos issued by him.
- All payments on the cash memo of the salesman must be made by the customer at the cash counter.

Sales are to be effected in the following manner:

- Three copies of the cash memo must be issued to customer.
- The customer must present the three copies of cash memo to the cashier at the time of making payment.
- The cashier must verify the particulars and satisfy himself regarding the total payment with reference to rates and quantity.
- The cashier on receiving the payment in cash will place a rubber stamp on all the copies of memos as “cash paid”.
- He will retain one copy with himself and hand over the other two copies to the customer.
- The customer must present the cash memos to the delivery department to collect the goods purchased.
- The delivery department will put rubber stamp on the memos as “goods delivered”. It will retain one copy as an evidence for delivery and hand over another copy of the memo to the customer.

At the end of the day’s working, the sales man, the cashier and the gate keeper should prepare the summary and submit to the manager or officer in charge. If these summaries tally, the accounts are certified as correct.

Postal sales i.e., sales under mail order includes following aspects:

- All sales made by post i.e., V.P.P should be recorded in a separate register to be maintained for the purpose.
- The goods returned, if any, should also be recorded in the register.
- The total amount of cash receipts including advance, if any, against the mail orders should be entered in the register and the same should be deposited into the bank.
- All the entries in the V.P.P. register should be checked by some responsible officer and special inquiries should be made in respect of those goods against which cash has not been received.
- There should be proper filing of mail orders received and the cash book should be checked with these mail orders.
2.9.4 Sales by Representative and Agents

It is the practice in big business houses to employ representative and agent to promote sales and to collect the amount due from debtors. The system of internal check to be introduced in this connection should be as follows:

- The representatives and agents should be authorised to issue rough receipts to the customers against cash received from them. However, the final receipt should be issued only by the head office.
- The customers should be advised to communicate directly with the head office if they do not get the final receipt within a reasonable time period.
Summary

- Examination in depth reconstructs the audit trail and reveals more about the functioning (or malfunctioning) of the client’s system in practice than the haphazard and mechanical approach to testing.
- Test checking means to select and examine a representative sample from a large number of similar items.
- Test checking is an accepted auditing procedure wherein instead of checking all transactions, only a part of it is checked in detail to form an opinion on the whole.
- Test check is normally planned in such a way that the audit programs for 3 to 5 years cover all types of transactions in case of a medium or large sized company.
- The extent of test checking would primarily depend on the Auditor’s judgment of a particular situation.
- The auditor is required to form an opinion on the financial statements.
- Application of test check principles involves the application of mind and intelligent judgment.
- The auditor assesses the risk of material misstatements in the financial statements in a scientific manner by drawing suitable samples and studying the same in detail.
- Establishing standards on the design and selection of an audit sample and the evaluation of the sample results is the job of Auditing and Assurance Standard (AAS).
- “Audit sampling” means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.
- Sampling risk arises from the possibility that the auditor’s conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.
- Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective.
- The auditor should select sample items in such a way that the sample can be expected to be representative of the population.
- Haphazard selection, which may be an acceptable alternative to random selection, provided the auditor attempts to draw a representative sample from the entire population with no intention to either include or exclude specific units.

References

- [INTRODUCTION TO AUDITING.](http://www.mu.ac.in/myweb_test/study%20TYBCom%20Accountancy%20Auditing-II.pdf) [Accessed 2 September 2013].
- *Internal Control & Internal Audit*. [Video online] Available at: <https://www.youtube.com/watch?v=DbnD9WgPhg> [Accessed 2 September 2013].

Recommended Reading

Self Assessment

1. __________ means to select and examine a representative sample from a large number of similar items.
   a. Auditing
   b. Test Checking
   c. Posting
   d. Tolerable error

2. __________ is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective.
   a. Tolerable error
   b. Expected error
   c. Tests of control
   d. Sampling risk

3. Match the following

<table>
<thead>
<tr>
<th>1. Risk of under reliance</th>
<th>A. The sample result supports the conclusion that a recorded account balance or class or transactions is not materially misstated.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Risk of incorrect rejection</td>
<td>B. The sample result does not support the auditor’s assessment of control risk.</td>
</tr>
<tr>
<td>3. Risk of over reliance</td>
<td>C. The sample results the supports the conclusion that a recorded account balance or class of transactions is materially misstated.</td>
</tr>
<tr>
<td>4. Risk of incorrect acceptance</td>
<td>D. The sample result supports the auditor’s assessment of control risk.</td>
</tr>
</tbody>
</table>

   a. 1-A, 2-C, 3-D, 4-B
   b. 1-C, 2-D, 3-A, 4-B
   c. 1-D, 2-A, 3-B, 4-C
   d. 1-B, 2-C, 3-D, 4-A

4. __________ involves selecting items using a constant interval between selections, the first interval having a random start.
   a. Systematic selection
   b. Expected error
   c. Sampling
   d. Test checking

5. AAS is applicable to which of the following methods?
   a. Any auditing technique
   b. Only to internal auditing
   c. Both the statistical sampling methods equally
   d. Only to routing checking
6. Which of the following statement is false?
   a. Test checking and sampling can never bring complete reliability; it cannot give accurate results.
   b. Test check is normally planned in such a way that the audit programs for 3 to 5 years cover all types of transactions in case of a medium or large sized company.
   c. If test checking becomes routine, predictable and mechanical, its value remains unchanged.
   d. The extent of test checking would primarily depend on the Auditor’s judgment of a particular situation.

7. __________ is the detailed checking of all transactional aspects such as casts, sub-casts, carry-forwards, extensions and calculations etc.
   a. Audit sampling
   b. Routine checking
   c. Test checking
   d. Sampling risk

8. ______ means the application of audit procedures to less than 100% of the items within an account balance about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population.
   a. Audit sampling
   b. Routine checking
   c. Test checking
   d. Sampling risk

9. Which of the followings is not an objective of an internal control?
   a. To ensure high degree of accuracy and reliability of accounting data and promote operational efficiency.
   b. To measure how far the policies of the management are being implemented.
   c. To evaluate the efficiency of performance in all aspects of business activities and to highlight the weaknesses.
   d. To issue rough receipts to the customers against cash received from them.

10. __________ is a system enforced in business under which the recording of business transactions is arranged in such a manner that the work of one staff member will automatically be checked by others in the course of recording of transaction itself.
    a. Internal check
    b. External check
    c. Test check
    d. Accounting check
Chapter III
Verification and Valuation of Assets and Liabilities

Aim
The aim of this chapter is to:

- introduce various aspects of verification
- explain valuation of assets
- explicate verification of assets like cash in hand and cash at bank

Objectives
The objectives of this chapter are to:

- explain goodwill of a company
- enlist methods of valuation
- define verification

Learning outcome
At the end of this chapter, you will be able to:

- determine leasehold property
- understand how to conduct verification
- recognise auditor’s position regarding valuation of assets
3.1 Introduction

Spicer and Pegler have defined verification as “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”. Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet. Thus, verification includes verifying:

- The existence of the assets
- Legal ownership and possession of the assets
- Ascertaining that the asset is free from any charge
- Correct valuation

Of course it is not possible for the auditor to verify each and every asset. It was held in Kingston Cotton Mills case that “it is not part of an auditor’s duty to take stock. No one contend that it is. He must rely on other people for the details of stock in trade in hand”. However, as per the decision given in Mc Kesson and Robins case (1939) the auditor must physically inspect some of the assets. Now the auditor has to report whether the balance sheet shows true and fair view of the state of affairs of the company. Hence, he is required to verify all the assets and liabilities appearing in the balance sheet. In case of failure, the auditor can be held liable for damages. According to the ‘statement of auditing practices’ issued by ICAI, “the auditor’s object in regard to assets generally is to satisfy that:

- They exist.
- They belong to the client.
- They are in the possession of the client or the persons authorised by him.
- They are not subject to undisclosed encumbrances or lien.
- They are stated in the balance sheet at proper amounts in accordance with sound accounting principles.
- They are recorded in the accounts.

3.2 Points to be Considered while Conducting Verification

While conducting verification following points should be considered by the auditor:

- Existence: The auditor should confirm that all the assets of the company physically exist on the date of balance sheet.
- Possession: The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.
- Ownership: The auditor should confirm that the asset is legally owned by the company.
- Charge or lien: The auditor has to verify whether the asset is subject to any charge or lien.
- Record: The auditor should confirm that all the assets and liabilities are recorded in the books of account and there is no omission of asset or liability.
- Audit report: Under CARO the auditor has to report whether the management has conducted physical verification of fixed assets and stock and the difference, if any, between the physical inventory and the inventory as per the book.
- Event after balance sheet date: The auditor should find out whether any event after the date of balance sheet has affected any items of assets and liabilities.

3.2.1 Scope of Verification

Verification includes information on the following:

- That the assets were in existence on the date of the balance sheet.
- That the assets had been acquired for the purpose of business only.
- That the assets had been acquired under a proper authority.
- That the right of ownership of the assets vested in the organisation.
- That the assets were free from any charge.
- That the assets were properly valued and disclosed in the balance sheet.
3.2.2 Objects of Verification
Following are the objects of verification of assets and liabilities:

- To show correct valuation of assets and liabilities.
- To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business.
- To find out the ownership and title of the assets.
- To find out whether assets were in existence.
- To detect frauds and errors, if any.
- To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
- To verify the arithmetic accuracy of the accounts.
- To ensure that the assets have been recorded properly.

3.2.3 Advantages of Verification
Advantages of verification are as follows:

- It avoids manipulation of accounts.
- It guards against improper use of assets.
- It ensures proper recording and valuation of assets.
- It exhibits true and fair view of the state of affairs of the company.

3.2.4 Techniques of Verification
There are various techniques of verification; some of them are listed below:

- Inspection: It means physical inspection of the assets i.e., company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.
- Observation: The auditor may observe or witness the inspection of assets done by others.
- Confirmation: It means obtaining written evidence from outside parties regarding existence of assets.

3.3 Verification of Assets
The term ‘verification’ signifies the physical examination of certain class of assets and confirmation regarding certain transactions. Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. Vouching proves the arithmetical accuracy and the genuineness of the transactions; whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the balance sheet date, rather it purports to prove that the asset ought to exist; on the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the balance sheet.

Verification of assets involves the following steps:

- Enquiry into the value placed on assets
- Examination of the ownership and title deeds of assets
- Physical inspection of the tangible assets and
- Confirmations regarding the charge on assets
- Ensuring that the assets are disclosed, classified and presented in accordance with recognised accounting policies and legal requirements.

The scope of verification is wide and consequently verification is an important part of the auditor’s duties. An auditor should put his entire endeavour to satisfy himself whether a particular asset is shown in the balance sheet at proper value, whether the concern holds the title to the asset and the asset is in the sole possession of the concern.
and lastly whether the asset is free from any charge. If the auditor fails to perform his duty, he will be held liable. In case of London Oil Storage Co. Ltd. Vs. Sear Hasluck & Co. (1904) Chief Justice Alverstone remarked “It is the duty of the auditor to verify the existence of the assets stated in the balance sheet and he will be liable for any damage suffered by the client if he fails in his duty.”

Besides the legal importance, verification also plays an important role to guard against improper valuation of assets like stock-in-trade which may inflate or deflate the profit position of the concern. Improper valuation of assets may also conceal the actual position of the business as reflected in the Balance Sheet. However, it is not possible on the part of the auditor to physically verify each and every asset because time may not permit him to do so, or he may not have sufficient technical knowledge of the assets concerned. It was decided in the case of “Kingston Cotton Mills: that it is not a part of an auditor’s duty to take stock. No one contends that it is. He must rely on other people for the details of the stock-in-trade.

Again, while going through the decision of Mc Kesson and Robins case in 1939, we find that the auditor should physically verify some of the assets. If possible, title documents like negotiable instruments, shares, debentures, securities, etc. are to be thoroughly examined on the last day of the accounting period. He should satisfy himself that the transactions, if any, having bearing on the Balance Sheet date and date of audit are bonafide and are supported with proper evidence. The auditor is also supposed to verify stock-in-trade with reference to the purchase book, the stock records, the gatekeeper’s book, etc. though law does not specially compel him to take stock-in-trade.

### 3.4 Valuation of Assets

Valuation of assets means determining the fair value of the assets shown in the balance sheet on the basis of generally accepted accounting principles. The valuation of assets is very important because over-statement or under-statement of the value of assets in the balance sheet not only distorts the true and fair view of the financial position but also gives wrong position of profitability. The valuation of the assets is the primary duty of the officials of the company. The auditor is required to verify whether the value ascertained is fair one or not. For this, he may rely on the technical certificate issued by the experts in the field.

Valuation of assets means not only checking value of the assets owned by an organisation as on balance sheet date, but also critical examination of the value of these assets (comparative analysis of different assets). The auditor has also to see that the principle of valuation of assets is consistently adopted and is based on established principles of accountancy. For the purpose of convenience, those assets are classified as under to determine their value:

- Fixed Assets
- Current Assets or Floating Assets
- Wasting Assets
- Intangible Assets
- Fictitious Assets

#### 3.4.1 Fixed Assets

Fixed Assets are usually valued at ‘going concern value’ which means cost less depreciation. Cost here means purchase price of the assets plus all incidental manufacturing, buying and installation expenses incurred to bring the assets in use. Depreciation is the provision made for the reduction in the value of the assets on account of their usage, natural wear and tear and obsolescence etc. The depreciation provided should be fair, otherwise the value of fixed assets may not be fair. What is a fixed asset depends on the nature of the business organisation.

#### 3.4.2 Current Assets or Floating Assets

These are usually converted into cash at the earliest opportunity in the process of business activity, e.g., stocks, bills receivables, sundry debtors, etc. Based on conservatism principle, usually current asset are valued at original value (cost price) or market value (realisable value) whichever is lower. Because they are intended to be converted into cash at the earliest possible time, hence what value we may realise is important. This method is adopted to strengthen the financial position of a concern by indirectly providing for expected loss by way of fall in the market value of the assets. This principle is held by the conservatism convention of accounting, i.e., do not expect profits but provide for anticipated losses.
3.4.3 Wasting Assets
Wasting Assets means those which lose their value gradually upon their use, e.g., a mine, a quarry etc. To value these assets firstly we should determine the usefulness of the assets in terms of units of production etc. and as per their actual use the value is to be reduced on proportionate basis. If in a particular period this type of asset is not used then the value may not diminish also. Thus, these assets are to be reduced on the basis of consumption. But sometimes it may be difficult to adopt this method, then the ‘cost less depreciation’ principle may have to be applied.

3.4.4 Intangible Assets
Usually intangible assets like goodwill, patent rights, know how, etc. are valued on cost basis. But if the same are acquired by a non-cash transaction, then the fair market value is to be taken as the value of intangible assets. Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realisable value. They are to be valued at actual cost less amount written off as depreciation up to balance sheet date.

3.4.5 Fictitious Assets
Certain lump sum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the balance sheet, e.g., preliminary expenses, discount on issue of shares etc. These are all fictitious assets because they do not have any realisable value. They are to be valued at actual cost less amount written off upto the balance sheet date.

3.5 Methods of Valuation
The following are the various principles of valuation of assets:

- Cost price (Going Concern Value): Under this method, actual costs of assets are reduced by the depreciation provided. Usually this method is applied to value fixed assets.
- Market value: This refers to the market value of the asset, i.e., the price at which the asset is being transacted in the market. This is applied to value the current assets only when this is lower than cost of the asset. Usually market value is adapted to value items having perishable nature.
- Scrap value: Assets which are useless for the enterprise may be sold as scrap in the market. The value, for which such assets can be disposed of as scrap, is called as scrap value of assets.
- Replacement value: This represents the value at which the existing assets can be replaced. That means the price to be paid to acquire such type of assets in the market on the date of the balance Sheet.
- Realisable value: The value that can be obtained if the asset is sold in the market i.e., anticipated selling price. Usually, expenses such as commission, brokerage etc. are deducted from it.

3.6 Auditor’s Position Regarding Valuation of Assets
So far as the valuation aspect of audit is concerned, the auditor’s position is somewhat different from the other aspects of audit. It has already been pointed out that the auditor is not supposed to have technical knowledge regarding the valuation of assets. Therefore, he has to depend upon the valuation made by the directors, experts, surveyors, etc, to a great extent. But does it relieve him from liability if certain assets are overvalued or undervalued by the directors, experts or surveyors etc?

The reply is definitely no, because the auditor cannot give a guarantee for absolute correctness or the state of affairs when he has to depend upon others, and also where assets are valued according to the estimated depreciation. He has to see that the management tries to show the fairest possible estimate of the position of the state of affairs of the concern. Under these circumstances, the auditor should see that assets are valued according to certain accepted principles of accountancy. He should check the estimation in a reasonable manner. The auditor in any case should thoroughly examine the available papers and documents to arrive at the correct value of assets. In case of a little suspicion as regards the valuation of assets he should probe into the matter.
3.7 Distinction Between Verification and Valuation

In this section we have distinguished verification and valuation with respect to various aspects.

- **Meaning:** Verification establishes existence, ownership and acquisition of assets whereas valuation certifies correctness of the value of assets and liabilities.
- **Time:** Verification is done at the end of the year whereas valuation is done during the year.
- **Personnel:** Verification is done by auditor whereas valuation is done by the proprietor himself.
- **Evidence:** The title deeds, receipts of payments constitute documentary evidence for verification where as certificate given by the proprietor is the documentary evidence for valuation.

3.8 Verification of Assets - Illustration

It includes cash in hand and cash at bank. We will discuss both in detail.

### 3.8.1 Cash in hand

Cash in hand includes all the following:

- Special care is necessary with regard to verification of cash balances. There can be no certainty that the cash produced for inspection was in fact held by the custodian.
- For this reason, the cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year without giving notice of the auditor’s visit either to the client or to his staff.
- If there is more than one figure for cash balance e.g., when there is a cashier, a petty cashier, a branch cashier and in addition, there are imprest balance with employees, all of them should be checked simultaneously, as far as practicable, so that the shortage in one balance is not made good by transfer of amount from the other.
- It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared, containing details and the cash balance counted. If he is absent at the time the cash is being verified, he may subsequently refute the amount of actual cash on hand which may put the auditor in an embarrassing position.
- If the auditor is unable to check balance on the date of the balance sheet, he should arrange with his client for all the balance to be banked and where this cannot conveniently be done in the evening of the close of the financial year, it should be deposited on the next day. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at close of the year.
- Should this not be possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash? This should be done soon after the cash balances have been counted. The cash book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked.
- If any cheques or drafts are included in cash balance the total there of should be disclosed.
- If there is any rough Cash Book or detail of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book, to prove that, entries in the Cash Book are correct.
- If the auditor finds any slip, chit or I.O.U’s in respect of temporary advances paid to the employees, included as part of the cash balance, he should have them initialled by a responsible official and debited to appropriate accounts.

### 3.8.2 Cash in Transit (Remittance in Transit)

Cash in hand includes following:

- This refers to amount sent by Branch/Depots/Agents etc. to Head Office but physical cash/cheques not yet received by H.O. or vice versa.
- Such remittance in transit should be verified from subsequent period cash book/pass book as to whether actually it is received or not.
- Reconciliation of H.O./Branch Accounts should also be checked.
- If amount is deposited into bank, pay-in-slip can also be verified.
- See that entry for remittance in transit is passed by only one party and is reversed in the next year.
3.8.3 Petty Cash
Petty cash contains the following factors:

- Petty Cash in hand should be verified with Petty Cash Book.
- Also check up the balance of Petty Cash Account in General Ledger.
- Vouch the transaction of last month property to ascertain that fictitious payments are not entered into.
- Some of the points given for verification of cash in hand will be applicable for Petty Cash also.

3.8.4 Bank Balance
Bank balance summarises the following points:

- To verify cash at bank, the auditor should examine the bank pass book and compare it with the balance as shown by the bank column of the cash book.
- Check bank reconciliation statement with bank statement / pass book of subsequent period.
- The auditor should get a certificate regarding the balance at the bank directly from the bank.
- Ensure that the balance as shown by the cash book is brought into the balance sheet as ‘Cash and Bank’ and not ‘Balance as shown by the pass book’.
- The auditor should also see that the ‘cheque outstanding’ and ‘cheques not yet collected’ are genuine and not made up in order to conceal the deficiency. If some of these cheques are more than six months old, he should make inquiries, and have them reversed in the books of accounts.
- Cash in Fixed deposits with the bank can be verified by examining the deposit receipt, or getting a certificate from the banker.
- If there are more than one bank account such as ‘Dividend Account’. ‘Interest Account’ etc. all such accounts should be checked and the balances should be verified upon the same date. Information regarding their balance should also be obtained from the bank directly.
- If the bank account shows an adverse balance and the client has deposited any security for the overdraft, the auditor should enquire from the bank the particulars of the security and the amount of the interest charged.

3.8.5 Bills Receivable
There are many things which should be taken care of:

- The auditor should examine the Bills Receivable Book with the Bills Receivable not matured but in hand on the date of the Balance Sheet.
- When any bills are in the process of collection the details of the same have to be verified with bank certificates.
- If the Bills Receivables in hand are many, auditor should make a list of bills for his convenience.
- If there are any bills that have been discounted, and still not matured, he has to examine the details of the same very carefully and should confirm with the bank because they are to be shown as contingent liabilities by way of a note in the balance sheet.
- While examining the bills, the auditor has to pay special attention to see that they are properly drawn, stamped and duly accepted.
- He has to check whether any bill is overdue. If so, auditor should ask for the details of the action initiated, etc. If there are any bills which are doubtful of recovery, he should see whether any adequate provision has been made for the anticipated loss on account of bad debts.
- He has to see that in case of dishonoured bills, the same is not shown as Bills Receivable. The auditor has also to check up whether noting formalities have been properly complied with or not.
- In case the auditor has visited his client after the balance Sheet date, many of the bills due on the Balance sheet date might have matured or honoured. Hence the auditor has to vouch such bills with Cash Book or Pass Book and reconcile the balance.
• If the bill has been renewed after the balance sheet date, then also the value of the original bill due on balance sheet date should be shown as Bills Receivable and interest on renewed bills properly accounted.

• If the bills endorsed have been dishonoured, the original drawee is to be debited and endorsee is to be credited.

### 3.8.6 Loans Advanced

Loans may be of different types like:

- Loans against the security of land and buildings
- Loans against the security of goods
- Loans against the security of stocks and shares
- Loans against the security of insurance policies
- Loans against the personal security of the borrower

Therefore, in each case, the duty of auditor in general is as follows:

- Verify whether object clause of the Memorandum provides for granting of such loans.
- Examining whether a proper loan ledger has been maintained and it is up-to-date or not.
- Examination of the security lodged against each loan. The loan agreement is to be scrutinised regarding the rate of interest. Due dates of installment, penalty, interest, etc.
- He should ascertain whether any loan is doubtful of recovery in which case a provision for the expected loss is to be made.
- Except in case of a banking or finance company, auditor has to ascertain whether the purpose of advancing is connected with business or not. Section 227(4A) of the Companies Act, 1956 requires an auditor to report whether the parties to whom the loans are given are regular in payment of interest and principal and the terms of the loan are not prima facie prejudicial to the interest of the company.

Loans against the security of land and building:

- The auditor has to examine the mortgage deed, see if the copy has been properly executed and registered in favour of the client.
- The auditor has to examine the title deeds deposited with the mortgage deed.
- The auditor, if required, has to examine the valuer’s certificate in order to ascertain the value and sufficiency of the security.
- The auditor has to confirm that the property is properly insured and insurance premiums have been paid in time.
- The auditor has to examine the title of the borrower to the property, etc.
- If the mortgage is a second mortgage, the auditor has to confirm that the same is brought to the knowledge of the first mortgagee. In this case he has to take the acknowledgement of title deeds from the first mortgagee.

Loans against the security of goods:

- The auditor has to examine the nature of the goods and confirm that the goods are really belonging to the borrower. He should see whether the loan is granted against railway receipt, lorry receipt, dock warrant, go down keeper’s receipt, etc.
- In case goods are stored in the go down, he has to see that the rent of the go down is paid in full and the goods are fully insured.
- The auditor should examine the value of the goods by comparing them with the present market value. Regarding quality and quantity, he may rely on the inspector’s reports.
- If the goods are of perishable nature, the auditor has to examine the turnover of the stock of the client.
Loans against the security of stocks and shares:

- He should call for a statement of stocks and shares given as security and confirm that all of them are fully paid up.
- He should see whether an instrument of transfer is properly stamped and is properly executed.
- He should see that their value is properly disclosed as per the prevailing market rates.
- He has to ensure that there is a sufficient margin on the loans advanced.
- He has to see whether the charge is properly registered or not.

Loans against the security of insurance policies:

- The auditor should see that the policy has completed at least two years.
- The auditor should confirm that all the premiums have been properly paid and the policy is in force by examining the latest premium receipt.
- The auditor should ascertain that due notice of assignment has been given to the insurance company.
- The auditor should see that the loan has been advanced on the basis of surrender value of the policy as certified by the insurance company.
- The auditor has to ensure that the premium, if any, paid up by the lender to keep the policy in force is properly debited to the loan account of the borrower together with the usual interest.

Loans against the personal security of the borrower: The auditor has to examine the documents like Promissory Note, Guarantor’s details and Salary Certificate of the borrower, etc.

Sundry Debtors represents the amount recoverable from the customers for sale of goods or rendering of services. The below mentioned procedure should be applied for verification of ‘Book Debts’ or ‘Sundry Debtors’ after receiving a schedule or list of debtors from the client.

- Direct confirmation of balances from debtors by sending confirmatory letters.
- Year-end Scrutiny of ledgers.
- Verification of the position of debts considered bad or doubtful.
- Compliance with legal requirement or presentation.

The auditor should arrange to send the letter of confirmation of balances by the client as per client’s records and see that the reply of confirmation is forwarded to his office directly. Usually this should be sent within 15 or 20 days of close of the year under the supervision of the audit staff. After the reply is received, the same should be tallied with the balances shown in the Debtors Ledger and difference properly reconciled. After the said procedure is carried out, he should carry out a thorough scrutiny of the debtor’s individual accounts. Wherever the number of debtors is very large, test checks can be applied. While scrutinising the ledger, the auditor should focus the light on discounts, returns, cash received, rebates allowed, goods returned etc.

On ascertaining the balances of the debtors as genuine and correct, the auditor has to verify the debtors to find out bad or doubtful debts to make a provision for the same. If the debts are bad and irrecoverable or doubtful and they are not provided for properly; the financial statements will not portray a ‘True and Fair’ view. Hence, appropriate provision is to be made by considering the age of the debtor, scrutiny of payments received, management opinion and any other information like financial position of debtors, etc. If the auditor fails in verifying the appropriateness of the provision made, he shall be held liable for negligence. After ascertaining the position of bad or doubtful debts, he should see that the legal requirements of Schedule VI to the Companies Act, 1956 are complied with. For this purpose, the debtors are to be classified as:

- Outstanding for a period of more than six months
- Other debts
Over and above this, other requirements like debts considered as good and which are fully secured, debts due from
the officers, directors, managers of the company, etc., are to be ascertained for disclosure. If the customers have
purchased the goods on hire purchase system and some of the installments are not due, the same is not to be shown
as ‘stock out on hire purchase’. Likewise, if the goods are sold on ‘return or approval’ basis, such customer cannot
be shown as a debtor at the close of the year. Further, whenever there are credit balances in some debtors account,
the same are not to be deducted from other debtors debit balances and net balance is not to be shown in the assets
side, but former is to be shown as Sundry Creditors.

3.8.7 Patent and Trademarks
Study the points below for patent and trademark:

• The ownership of patent rights is verified by inspection of certificate issued for grant of patent, by the prescribed
  authority.
• If it has been purchased, the agreement surrendering it in favour of the client should be examined.
• If there are a number of patents held by the client, obtain a schedule giving the full details thereof or verify with
  reference to the register maintained by the client.
• It must be verified that patent rights are alive and legally enforceable and renewal fees have been paid on due
dates and charged to Revenue Account. The last renewal receipt should be examined to ascertain that the patent
has not lapsed.
• See that the patents are properly registered in the name of the client only.
• See that the cost of patent is being written off over its useful period of life.
• In case the patent is acquired, cost paid for the same and all relevant expenses are to be capitalised.
• If the patent is created by the client by the research experiments and laboratory work, only the actual expenses
  incurred for it in the process are to be capitalised.

3.8.8 Copyrights
Copyright says:

• The auditor has to examine the written agreement of assignment along with the royalty paid to the authors etc.,
  for such copyrights.
• He has to see that such assignments are properly registered.
• If the client is the owner of many copyrights, the auditor should ask the client to prepare a schedule of copyrights
  and get the detailed information to confirm that the same is shown in the balance sheet.
• Regarding the value of copyrights, it should be remembered that this asset has no value in the long run. Hence,
  value is determined on revaluation basis and period of copyrights.
• If any copyright does not command the sale of any books, then the same should be written off in such year. The
  auditor has to verify the same in detail.

3.8.9 Know-how
Know how is explained in the section below:

• Know how is recorded in the books only if it has been paid for. If it is developed in house, it cannot be capitalised.
  The auditor should keep his in mind while verifying know-how.
• Know-how can be of two types:
  • Relating to manufacturing process: The auditor should ensure that the expenditure is written off in the year
    of payment itself.
  • Relating to design plans of plants, building etc.: The auditor should ensure that the expenditure is capitalised
    and depreciation is charged on the capitalised figure.
In case lump sum payment is made for both types of know how, both the types should be segregated on a reasonable
basis. Under the Income-Tax Act, cost of Know-how can be deducted subject to the rules laid down. The auditor
should keep this fact in mind while computing the tax liability for the year under audit.
3.8.10 Investments
Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc. For verification of such securities, the following procedure is adopted:

- Obtain a schedule of investments in hand at the beginning of the audit period. Obtain the details of description of investments together with distinctive number of face value, date of purchase, book value, market value, rate of interest, date of payment of interest or, date around which dividend is declared, etc., with also the details of interest or dividend received along with tax deducted at source.
- Add to the above list, purchase made during the year and delete the investments sold during the year with all the above details.
- Balance this schedule and compare the balance with general ledger and balance sheet.
- Check the market value of investments with reference to stock exchange quotations or other suitable method, on balance sheet date and see that the values are disclosed in the balance sheet.
- Inspect the certificates or securities physically on the balance sheet date.
- Compare the income received with amount due and adjust the accrued income.
- Confirm the uncalled liability on partly paid shares held as investment shown as contingent liability by way of a note to the balance sheet.
- See that adequate provision is made for any shortfall in the book value of investment shown in the balance sheet.
- See that, regarding the investment in subsidiaries, disclosure requirement of section 212 of Schedule VI of the Companies Act, 1956 are complied with.
- For investment in the capital of partnership, the partnership deed and copy of accounts of partnership firms, is to be verified. Also adjust the share of profit and loss for the partnership period.
- Investments which stand in the name of persons other than that of the company are to be confirmed with appropriate sanction.
- For investment lodged with others as security or lying with banks or share brokers, obtain a certificate from the parties concerned.
- In case of application money paid for shares which are still to be allotted, that fact is to be specially disclosed in the balance sheet.

3.8.11 Leasehold Property
Normally the lease or right to use the property is granted for certain number of years. At the expiry of the period of lease, the rights go back to the original lesser. Various steps involved in the verification of leasehold rights are stated below:

- Inspect the lease agreement to ascertain the amount of premium paid, period of lease, other terms and conditions, like maintenance, insurance, etc.
- See that the lease is properly registered with the registrar because a lease for a period exceeding one year is not valid unless it has been granted by a registered document.
- Ascertain those conditions, the failure of which might result in the forfeiture or cancellation of lease, and see whether they have been properly complied with.
- See whether sub-lease is valid as per lease agreement, in case if it is granted, by referring to sub-lease agreement.
- See that the premium paid and acquisition expenses of lease are being amortised (written off) over the period of lease adopting a suitable basis.
- In case, any provision is to be made under the dilapidation clause for payment on the expiry of the term of lease, see that the same is properly and continuously provided.
- In case of leasehold land, if any building is constructed by the lessee, see the position and ascertain the correct method of presentation of such expenditure for disclosure in the balance sheet.
3.8.12 Goodwill
Whenever the company has purchased or acquired a running business and has paid for it an amount, in excess of the book value of its net assets, the excess is called ‘Goodwill’. It can be verified from the vendor’s agreement and the auditor has to see whether there is a specific sum which is paid or whether it is the excess of price paid over the tangible assets and see that it is properly recorded. When the company has written up the values of all its assets on a revaluation and has raised a Goodwill Account in the books, the Goodwill appears in the Balance Sheet. In this case, the auditor has to see the basis of valuation and get satisfied about the same. If he is not satisfied, the fact should be reported to the shareholders.

He has to see that such excess is credited to a Capital Reserve or Revaluation Reserve and no dividend is being declared from it. He has also to see the disclosure requirement of Schedule VI and ensure that the facts are disclosed for 5 years subsequent to the date of revaluation. Sometimes, Goodwill which is written off earlier may be brought back in the books of account to adjust the debit balance of profit and loss account. In this case, the auditor should investigate the fact and satisfy in full before approving such method of creating Goodwill. He should also refer to the board resolution. In case he is not satisfied, the fact should be reported to the shareholders. If Goodwill has been created by any other means, the auditor should see that all relevant facts are properly disclosed and are supported by documentary evidence.

3.8.13 Plant and Machinery
Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc. Therefore, the auditor should ask for such a register maintained by the client and see that all items of plant and machinery are recorded properly giving full details. As per the provision of the same section, all fixed assets are required to be physically verified by the management. Therefore, the auditor should enquire whether such physical verification was undertaken or not. If yes, he should ask for necessary papers pertaining to the same. If there is any discrepancy, reasons for the same should be asked.

Any new purchases made during the year are to be verified with reference to purchase invoice and other papers regarding installation of the same. Total value of plant and machinery as shown by Fixed Asset Register should tally with ledger account maintained in the financial books. Where any item of plant and machinery is sold, scrapped or transferred the auditor should check relevant entries for the same and verify that they are removed from the Fixed Assets Register. The auditor should verify that adequate depreciation is provided on all items of plant and machinery and method of depreciation is consistently followed from year to year. Auditor should see that the entire plant and machinery stands in the name of the client and are free from any charge or encumbrances. If plant and machinery is mortgaged, then he has to verify that the documents are properly executed and mention of mortgage is made in the balance sheet.
Summary

- Spicer and Pegler have defined verification as “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”.
- The auditor should confirm that all the assets of the company physically exist on the date of balance sheet.
- The term ‘verification’ signifies the physical examination of certain class of assets and confirmation regarding certain transactions.
- Vouching proves the arithmetical accuracy and the genuineness of the transactions; whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge.
- The scope of verification is wide and consequently verification is an important part of the auditor’s duties.
- Valuation of assets means determining the fair value of the assets shown in the balance sheet on the basis of generally accepted accounting principles.
- Valuation of assets means not only checking value of the assets owned by an organisation as on balance sheet date, but also critical examination of the value of these assets (comparative analysis of different assets).
- Wasting Assets means those which lose their value gradually upon their use, e.g., a mine, a quarry etc.
- Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realisable value.
- Certain lump sum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the Balance Sheet, e.g., preliminary expenses, discount on issue of shares etc.
- The auditor should arrange to send the letter of confirmation of balances by the client as per client’s records and see that the reply of confirmation is forwarded to his office directly.
- On ascertaining the balances of the debtors as genuine and correct, the auditor has to verify the debtors to find out bad or doubtful debts to make a provision for the same.
- Investment may be a share certificate, government bond certificate, government loan certificate, debenture certificate, etc.
- Now-a-days as per provision of Section 227(4A) of the Companies Act, 1956 every company is required to maintain a Fixed Asset Register showing full particulars including cost, location, depreciation, details of purchase, expenses capitalised, etc.

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- Accounting Lecture 10 - Petty Cash. [Video online] Available at: <https://www.youtube.com/watch?v=nRy2TGmTicc> [Accessed 2 September 2013].
- Intellectual Property: Patents, Trademarks, and Copyright. [Video online] Available at: <https://www.youtube.com/watch?v=qFRAamWjYG0> [Accessed 2 September 2013].

Recommended Reading

- Basu, K. S., Contemporary Auditing: For Chaudhary Charan Singh University. Pearson Education India.
Self Assessment

1. _______ implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets.
   a. Spicer
   b. Pegler
   c. Verification
   d. Valuation

2. Which of the following statement is false?
   a. The auditor should confirm that all the assets of the company physically exist on the date of balance sheet.
   b. The auditor has to verify that the assets are in the possession of the company on the date of balance sheet.
   c. The auditor should confirm that the asset is legally owned by the company.
   d. It is not necessary for the auditor to verify whether the asset is subject to any mortgage or lien.

3. _______ proves the arithmetical accuracy and the genuineness of the transactions; whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge.
   a. Assets
   b. Vouching
   c. Cost price
   d. Shares

4. Match the following

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1. Cost Price</td>
<td>A. The price at which the asset is being transacted in the market</td>
</tr>
<tr>
<td>2. Market Value</td>
<td>B. The value at which the existing assets can be replaced</td>
</tr>
<tr>
<td>3. Scrap Value</td>
<td>C. Actual cost of assets are reduced</td>
</tr>
<tr>
<td>4. Replacement Value</td>
<td>D. Assets which are useless for the enterprise may be sold as scrap in the market</td>
</tr>
</tbody>
</table>

   a. 1-D, 2-C, 3-B, 4-A
   b. 1-C, 2-A, 3-D, 4-B
   c. 1-A, 2-C, 3-D, 4-B
   d. 1-B, 2-D, 3-A, 4-C

5. Which value is obtained if the asset is sold in the market?
   a. Realisable Value
   b. Cost Price
   c. Scrap Value
   d. Market Value

6. The value, for which such assets can be disposed of as scrap, is called as _________ of assets.
   a. realisable value
   b. cost price
   c. scrap value
   d. personal value
7. Which of the following statement is false?
   a. Verification is done during the year whereas valuation is done at the end of the year.
   b. Verification is done by auditor whereas valuation is done by the proprietor himself.
   c. The title deeds, receipts of payments constitute documentary evidence for verification whereas certificate given by the proprietor is the documentary evidence for valuation.
   d. Verification establishes existence, ownership and acquisition of assets whereas valuation certifies correctness of the value of assets and liabilities.

8. ________ represents the amount recoverable from the customers for sale of goods or rendering of services.
   a. Spicer
   b. Pegler
   c. Sundry Debtors
   d. Other debts

9. The auditor has to examine the written agreement of assignment along with the royalty paid to the authors for ________.
   a. know how
   b. investments
   c. property
   d. copyrights

10. __________ is developed in house, it cannot be capitalised.
    a. Know how
    b. Payment
    c. Leasehold Property
    d. Goodwill
Chapter IV
Review and the Audit Process

Aim
The aim of this chapter is to:

• introduce process of review and audit of internal control systems
• explain benchmarking
• explicate objectives of directors

Objectives
The objectives of this chapter are to:

• explain internal audit control system
• enlist various types of auditing
• define materiality

Learning outcome
At the end of this chapter, you will be able to:

• distinguish between ICQ and ICEQ
• understand documenting the accounting system
• identify the planning process
4.1 The Process of Review and Audit of Internal Control Systems

Board of directors and management play an important role in any company. The board of directors is responsible for the review and maintenance of internal controls whereas management of the company is responsible for the devising and implementing these controls. The focus of the Turnbull Report (1999) is always on the review of internal controls and it has also become a part of the Combined Code.

Following are the key points in the Turnbull Report:

- Have a defined process for the review of effectiveness of internal control.
- Review regular reports on internal control.
- Consider key risks and how they have been managed.
- Check the adequacy of action taken to remedy weaknesses and incidents.
- Consider the adequacy of monitoring.
- Conduct an annual assessment of risks and the effectiveness of internal control.
- Make a statement on this process in the annual report.

Internal audit is used to help directors achieve these objectives:

Fig. 4.1 Objectives of directors

Conformance, compliance and efficiency focus on the administration of decisions. Processes and procedures should be regularly reviewed. This would ensure that decisions are made on results of the company that are timely, accurate and relevant. Audit programs and procedures should be drawn up ensuring effective coverage of financial, management, operational and compliance issues. For example, reporting standards, regulations, health and safety, security and competition.

Performance and business risk focus on the quality of decisions. The comparison of an organisations performance with that of the others is an important part of performance measurement, identifying organisations not necessarily in the same industry as ‘yard stick’ for which performance can be compared to. The board must identify the key risk areas and key performance indicators of the business and continually monitor and compare these to improve the business processes and help safeguard against any impact by competitors. Management makes detailed reports on these benchmarks to the board to help them carry out this monitoring process.
4.2 Benchmarking

Benchmarking is a continuous, systematic process for evaluating the products, services and work processes of an organisation that are recognised as representing best practice, for the purpose of organisational improvement.

There are four types of benchmarking. A hospital is used to illustrate the following types of benchmarking:

- **Internal**: Compare an internal function to ‘the best internally’ within the same organisation, e.g., different methods of cleaning used by hospital wards within the same hospital.
- **Best practice or functional**: Compare an internal function to ‘the best’ but not necessarily an organisation in the same industry, e.g., compare administration activities or cleaning methods to other hospitals or other organisations other than a hospital not involved in healthcare.
- **Competitive**: Hospital or healthcare services are compared to that of rival ‘competition’ in the same industry, e.g., methods of patient care and levels of service compared and contrasted with other hospitals.
- **Strategic**: Comparison in terms of an organisations ‘strategic choices’ made to the most successful market leader, e.g., review organisational structure, culture, mission statement and goals of other hospitals higher in ‘quality league tables’. Strategic choices could include outsourcing or decisions about the closure of expensive wards even though unpopular.

Companies should:

- set up where customers perceive differences
- set the very best standards to exceed
- found what the competition is doing
- encourage staff, manage knowledge, ideas and innovate to exceed

A process for benchmarking includes the following:

- Gain senior management commitment to establish benchmarking as a process within the organisation and educate staff and stakeholders about the benefits. Participate and consult with staff and stakeholders.
- Consider the benefits against the cost for each activity to be benchmarked to ensure economic or financial justification.
- Assign responsibilities to a team of staff, e.g., set goals; establish BM processes and systems, checklists and documentation.
- Identify potential partners and known leaders.
- Undertake the process of benchmarking, e.g., test, measure, observe, experiment or investigate.
- Gather, analyse and summarise information collected and documented.
- Gap analysis undertaken for deficiencies identified, e.g., standard vs actual.
- Implement improvement, e.g., new programs, processes and procedures. Education and participation encouraged by those affected, avoid being over critical for weaknesses identified. Set objectives and manage change.
- Monitor and repeat regularly to discourage complacency, follow up improvements implemented to ensure the expected benefits are realised.

The following list provides the benefits of benchmarking:

- Better understanding of the business, competition and customers.
- Improves business performance and discourages complacency.
- Good way of comparing competitive strategies to reposition products.
- An organisation can learn from other organisations mistakes.
- You don’t need to ‘re-invent the wheel’ for innovation and creativity, e.g., learn from other organisations and a source of new ideas.
- Advance warning for deteriorating competitive performance, e.g., faster awareness of industry innovation and other competitor decisions.
• Fewer complaints, product returns, and warranty claims, e.g., quality improves.
• Leaner and more cost efficient organisation.
• Customer satisfaction and brand loyalty increases.
• Sales and profitability will improve in the long-term.

4.2.1 Drawbacks of Benchmarking
Benchmarking systems and programs can be costly and time consuming. The diversity and complexity of information can 'overload' management, e.g., so much information; management cannot see the wood through the trees. Obtaining information to actually undertake a BM exercise can be a problem, e.g., absent, historical or out of date. Confidential information could be leaked or compromised when shared.

Deciding who the ‘best in a class’ is?
Keeping staff motivated, e.g., staff can be criticised and once they exceed standards the standard is normally raised. The board should set clear lines of accountability and assignment of responsibility to the appropriate managers through the company. Management should report to the board their review and implementation of internal controls and risk management systems.

The board should review the performance of management in dealing with internal controls and risk management systems. They normally have assistance in this area from internal audit. Internal audit is an appraisal or monitoring activity established by the board for the review of the accounting and internal control systems as a service to the entity. It functions amongst various other things; it also examines, evaluates and reports to the board on the adequacy and effectiveness of components of the accounting and internal control systems created by management. Internal audit is seen as independent from management who are devising and implementing the internal controls, and should be able to provide advice on internal controls both to management and the board. Internal audit being independent from management can also review and advise on the audit the risk management process used by management to systematically identify the risk impacting the business.

The board should encourage a strong control culture. Manager’s bonus should not only be linked to company profits but also linked to internal control procedures being adhered to. There should be a specific manager who is responsible and accountable for internal control procedures for each division and who understands the details of that division.
Fig. 4.2 Internal control system

ICQ = Internal Control Questionnaire
ICEQ = Internal Control Evaluation Questionnaire
4.3 Internal Controls

Internal controls comprise the control environment and control procedures. Internal control includes all the policies and procedures (internal controls) adopted by the management. Entity to assist in achieving management’s objective of ensuring, as far as practicable should:

- orderly and efficiently conduct its business
- include adherence to management policies
- safeguard the assets
- prevent and detect the fraud and error
- maintain the accuracy and completeness of the accounting records
- be timely preparation of reliable information

Internal controls can be incorporated within computerised accounting systems. The internal control system also extends beyond those matters which relate directly to the accounting system.

Specific control procedures should be in place and it includes:

- Organisational structure (clear lines of responsibility and authority)
- Authorisation (approval of transactions or limits)
- Personnel (recruitment of trustworthy individuals and the right training)
- Supervision (discourages fraud and improves quality data entry when the work is complex)
- Physical (physical barriers to prevent theft)
- Accounting (reconciliation’s, trial balances and input controls)
- Segregation of duties (separate responsibilities between those that record, process and initiate, such as the receipt, recording and banking of cash)
- Management (internal audit, regular review of management accounts and exception reporting)

4.4 Types of Audit

Assess the adequacy of a system as a basis for the preparation of accounts is the main audit objective.

How effective is the accounting & internal control system?

<table>
<thead>
<tr>
<th>Low risk?</th>
<th>High risk?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design &amp; perform <strong>TESTS OF CONTROL</strong> if he wishes to rely on them.</td>
<td>Design &amp; perform <strong>SUBSTANTIVE TESTS</strong>. Report weaknesses to management.</td>
</tr>
<tr>
<td>This is a cost effective approach.</td>
<td></td>
</tr>
</tbody>
</table>

**Fig. 4.3 Effectiveness of accounting and internal control system**

**Tests of control or systems based auditing**

Tests are obtaining audit evidence about the effective operation of the accounting and internal control systems. Tests of control or systems based auditing is not concerned about the detailed underlying transactions but interested in the controls that are in place which manage the information. It is testing that the control is properly designed, exists and has operated throughout the period.
Deviations should be recorded and investigated regardless of the amount involved and then assess whether deviations are isolated departures or indicate existence of errors in accounting records. If replies are unsatisfactory then the preliminary assessment of control risk is not supported. The auditors necessarily modify the nature, the timing and the extent of their planned substantive procedures.

Systems based audit is useful as it will help identify risks within the processes in an organisation and review how adequate the controls are which mitigate these risks. This will help in achieving the businesses main objectives as processes will be in line to operate effectively and efficiently after such an audit. Examples of tests of controls are as follows:

• check bank reconciliation gets reconciled as it gets approved by chief accountant
• observation of buyer checking of the goods received, notation and invoice before authorising cheque for payment

Tests of controls may include:

• Enquiries and observations corroborating internal control functions.
• Documents evidence operation of an internal control after inspection, for example a transaction has been authorised.
• Evidence of management reviews should get examined, for example minutes of management meetings at which financial results are reviewed and corrective action decided on.
• Control procedures can re-perform, for example reconciliation of bank accounts, to ensure they were correctly performed by the entity.
• Testing of the internal controls operating on specific computerised applications or over the overall IT function, for example access or program change controls.

Alternative summarised versions of tests of controls are as follows:

• Documentation (written evidence)
• Segregation of duty, (i.e., staff records are separate from wages department)
• Authorisation (by senior personnel)
• Review (by senior personnel of other staff work)

Remember no control is foolproof. Humans are careless, distracted easily, misinterpret and make mistakes. Collusion can always happen to over ride controls and responsibility given could always be abused.

Substantive tests or transactions based auditing

Substantive tests or transactions based auditing is to obtain audit evidence to detect material misstatements in the financial statements. Using analytical procedures and other substantive tests to review the accuracy of the accounting information, for example testing transactions and balances, review of minutes of directors meeting and enquiry. Examples of substantive tests are as follows:

• Agree a sample of wages payments to the existence of these individuals and personnel records.
• Agree a sample of cashbook payments to the bank statements.
• Agree a sample of quantities on purchase invoices to goods received notes.

Risk-based auditing

A risk based audit would be reviewing the risk management process and considering the main risks of the organisation as a whole. Risk management procedures are used to assess what risks will impact on the business. These are not only within the organisation but much wider and look outside the business externally into its environment. If these risks are not mitigated then the business maybe severely affected resulting in the business not continuing in the future. Examples are competition, latest business developments, the state of the economy and social trends.
4.5 Planning

Internal auditors should plan the audit work so as to perform the audit in an effective manner. There should be adequate audit programs in existence which set out the purpose and the aim of the audit. Three main types of audit plans are as follows:

- **Strategic:** This is the long term forward looking audit; it continually gets updated and identifies areas of audit importance.
- **Tactical:** This looks at plans for the coming year, time tabling resource allocating and identifying the main audit objectives taken from the strategic plan.
- **Operational:** Detailed audit program for each and every specific audit.

Planning the work

Planning at work is listed below:

- Determine the scope and objective of the audit (to verify assets, to check adequacy of internal controls etc.).
- In risk based audit ensuring appropriate attention is devoted to the different areas of the audit.
- Changes in business environment (new systems, changes in key personnel, competitor’s reactions, innovations in the market, consumer preferences, legislation, board decisions etc.)
- Consider external auditors work already done.
- Review previous accounts, internal audit reports and past testing (analytical review and previous problems highlighted).
- Planning the work include ensuring the potential problems and their identified.
- Facilitating review.
- Ensure audit work is assigned and coordinated properly (select team, book hotels, communicate, brief and allocate work schedules).
- Planning of economic service within an appropriate time scale.

Audit plan contents are as follows:

- Report requirements and terms of reference
- A review of the business and financial position, reviewing why changes had occurred in the current year
- Risk areas highlighted including assessment of internal controls
- Calculations for levels of materiality
- Detailing overall audit approach (substantive or compliance) including timing and deadlines
- Staffing levels and request for any specialists i.e. computer based control assurance staff
- A budget for time estimated for each staff member
- Reviewed and approved by manager
- Distribute audit plan to all staff on the audit

The audit team should be sufficiently familiar and fully briefed by the manager and have knowledge of the business or operation such that to be able to carry out the audits work effectively.
### 4.6 The Audit Process

The process of audit is explained with the help of the figure.

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>Determine scope of the audit</td>
</tr>
<tr>
<td>(2)</td>
<td>Ascertain the system</td>
</tr>
<tr>
<td>(3)</td>
<td>Record the system</td>
</tr>
<tr>
<td>(4)</td>
<td>Confirm the system (Walk-through checks)</td>
</tr>
<tr>
<td>(5)</td>
<td>Evaluate the controls (Preliminary evaluation)</td>
</tr>
<tr>
<td>(6)</td>
<td>Select and carry out compliance tests</td>
</tr>
<tr>
<td>(7a)</td>
<td>Select and carry out substantive tests</td>
</tr>
<tr>
<td>(7b)</td>
<td>(a) Final evaluation of internal controls (b) Assessment of accounting records and systems</td>
</tr>
<tr>
<td>(8)</td>
<td>The final audit including review of financial statistics</td>
</tr>
<tr>
<td>(9)</td>
<td>THE AUDIT OPINION</td>
</tr>
</tbody>
</table>

### 4.7 Understanding the Accounting System

The following points are being used by the auditors to understand the system.

- Tracing one or more transactions through accounting system and observing application of internal controls. This is also known as the “Walk-through tests”.
- Review of prior year file and previous experience of reliability of system.
- Enquiry of management and personnel.
- Review of procedures manuals and systems descriptions.
- Examine documents / records produced by systems.
- IT functions and the nature of transaction processing is included with observation of the activities and operations.
4.8 Materiality

An item can be considered material if its omission would reasonably influence the decisions of an addressee of the report, a misstatement is material if it would have a similar influence. It can be of value, nature or disclosure. This will always be a matter of judgment for the auditor but should be engaged in seeking “material” errors, omissions and misstatements. Material items will have an impact on:

- Audit tests carried out. For example compliance based testing (relying on controls) may not be suitable as they would not be reliable enough to take assurance from, and therefore you may have to resort to detailed substantive tests (account balance level testing).
- Whether adjustments should be made to the accounts.
- Whether the auditor should qualify his report on the accounts.

The calculation of materiality

For example:

- Turnover: 1% - 1.5%
- Net assets: 1% - 2%
- Net profit: 2% - 6%

Whatever numbers are selected they would be based on the reliability and confidence the auditor places on the:

- Department manager’s integrity, (e.g., motive to maximise profits because bonus linked)
- The quality of the financial statements, (e.g., qualified staff to produce the accounts)
- Any other factors affecting the auditor’s judgment.

In addition to looking at the material differences individually the auditor should list all the differences (material or not) and consider in total whether they are material (list of uncorrected differences) or not. Tolerable error (TE) is the maximum error in the population that the auditors are willing to accept and still conclude that the audit objective has been achieved.

### Fig. 4.5 Control and substantive testing

<table>
<thead>
<tr>
<th>Controls testing</th>
<th>Substantive testing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Max rate of deviation from a prescribed control procedure</td>
<td>□ Max monetary error</td>
</tr>
<tr>
<td></td>
<td>□ Can be materiality rate</td>
</tr>
<tr>
<td></td>
<td>□ But usually a % of materiality for safety reasons</td>
</tr>
</tbody>
</table>

4.9 Audit Risk

Audit risk obtains understanding of the accounting and internal control systems. It is sufficient to plan the audit and develop effective audit approach. It has the ability of professional judgment to assess the audit risk components. Design procedures to ensure it is reduced to an acceptable low level audit risk that the auditor may give an inappropriate opinion on financial statements. Also known as the “ultimate risk”
4.9.1 Inherent Risk

Inherent risk misstatement either individually or when aggregated with misstatement in other balances or classes, irrespective of related internal controls.

While assessing the level of inherent risk some factors should be considered at entity level; they are listed below:

- Integrity of management
- Over reliance on key customers
- Management’s experience and knowledge
- Unusual pressures on management, (e.g., tight reporting deadline)
- Nature of entity’s business, (e.g., high technology industry)
- Economic conditions

At account balance / class of transaction level the factors to be considered while assessing the level of inherent risk are as follows:

- Balances susceptible to misstatement
- History of errors
- Complexity of transactions
- Degree of judgment involved in determining account balances
- Susceptibility of assets to loss or misappropriation
- The quality of accounting systems
- Unusual or complex transactions at year end
- Transactions which are not subject to normal processing

4.9.2 Control Risk

That material misstatement could occur and not be prevented, or detected on a timely basis, by the accounting and internal control systems. All audits at their core are substantive. Effective internal controls, (i.e., when CR is low) will reduce (not eliminate) substantive work. However, must consider cost/benefit of audit approach.

Tests of control should be performed by the auditor at the planning stage. This is to obtain audit evidence about the effective operation of the accounting and internal control system and assess the level of control risk. An appropriate audit plan can be produced based on this assessment.
4.9.3 Detection Risk
This is the risk that the auditors’ substantive procedures do not detect a material misstatement in an account balance or class of transactions. It is primarily the consequence of the fact that auditors do not, and cannot, examine all available evidence. Having assessed inherent risk and control risk, detection risk is then the balancing figure set to achieve an acceptable total audit risk.

4.10 Documenting the Accounting System
Clients system can be documented using three commonly used methods:

Narrative notes: Written description of the system
The advantages of narrative notes are as follows:
- It is comprehensive.
- It’s easy to delegate.
- It has the story approach.
- It is sufficient for small or simple systems.

The disadvantages of narrative notes are as follows:
- Difficult to update if hand written.
- Difficult to digest if complex system.

Flowcharts
Flowchart depicts in outline the sequence of events in a system showing document flow and the department or function responsible for each event.

The advantages of flowcharts are as follows:
- It makes easy reading and understanding for larger more complex systems.
- It highlights key features and controls.
- It is standardised.
- It is easy to update and little narrative.

The disadvantages of flowcharts are as follows:
- It requires formal training to understand notation used.
- It is time consuming to prepare.
- It may miss out crucial detail because of little supporting narrative.

Checklists or questionnaires
The audit firm will have a standard list of control questions. The audit staff can quickly ascertain which if any, are in operation by the client. There are two types; the internal control questionnaire (ICQ) and the internal control evaluation questionnaire (ICEQ). ICQ’s are designed to assess whether a control exists whereas ICEQ’s are designed to assess whether errors or frauds are possible.

The advantages of checklists are as follows:
- Comprehensive as narrative and should therefore cover all controls
- Standard questionnaires with a little tailoring for the specific business
- Easy to amend and update
- Easy to delegate
- Highlights key features and controls
- Good for preliminary assessment of controls
The disadvantages of checklists are as follows:

- Is not visual or diagram based and not easy to quickly understand
- Client are able to mislead on the effectiveness of controls
- Controls operated by client may not be identified because of standardised questionnaire
- It may contain large number of irrelevant controls

**Examples of ICQ’s and ICEQ’s**

**ICQ:** “Does an authorised senior person review the purchase invoices before payment is made?”

**ICEQ:** “Can payments be made on purchase invoices which have not been approved by an authorised senior person?”

**ICQ’s designed to:**

- Discover existence of internal controls
- Identify possible areas of weakness

Questions are framed in order to highlight situations where:

- NO sub-division of duty
- NO controls
- NO control by management supervision

**ICEQ’s go further than ICQ’s:**

- Discover whether error or fraud is possible
- Concentrates on the important errors or frauds that might be possible and so only a handful of key control questions needed
- Describes the nature and extent of the control that is being tested
- Records tests conclusions and how substantive tests are affected

### 4.11 Analytical Procedures

Auditors should apply analytical procedures at the planning and overall review stage of the audit. Analytical procedures include the consideration of comparisons of the entity’s financial information with various factors such as:

- Comparable information for prior periods
- Anticipated results of the entity, from budgets or forecasts
- Predictive estimates prepared by the auditors, such as estimation of the depreciation charge for the year end
- Similar industry information, such as comparison of the entity’s ratio of sales to trade debtors with industry averages, or with the ratios relating to other entities of comparable size in the same industry
- Between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees

It is good for the auditors to apply analytical procedures at the planning stage to assist in understanding the entity’s business in identifying areas of potential audit risk and in planning the nature, timing and extent of other audit procedures. When intending to apply analytical review as a substantive procedure, the auditors consider a number of factors such as:
<table>
<thead>
<tr>
<th>Factor</th>
<th>Impact on use</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plausibility/predictability of relationships</td>
<td>If relationship is strong (e.g. commission on sales) analytical procedure may suffice.</td>
</tr>
<tr>
<td>Degree of disaggregation of available information</td>
<td>Procedures are more effective when applied to components.</td>
</tr>
<tr>
<td>Availability of financial and non-financial data</td>
<td>Independently prepared non-financial data will allow more effective procedures.</td>
</tr>
<tr>
<td>Relevance of information</td>
<td>Budgets based on expectation are more useful than targets.</td>
</tr>
<tr>
<td>Comparability of information</td>
<td>Broad industry data (e.g. RPI) may not be relevant to specialised industry.</td>
</tr>
<tr>
<td>Knowledge gained previously</td>
<td>Effective procedures are based on recognising unusual/unexpected variations. If knowledge is limited, it is difficult to know what to expect.</td>
</tr>
<tr>
<td>Reliability of various forms of data</td>
<td>If data used is unreliable, then any results are equally unreliable therefore procedures less effective.</td>
</tr>
<tr>
<td>Nature of enterprise and its operations</td>
<td>Some businesses lend themselves to analytical procedures because steady trends develop therefore easier to know what to expect and spot variations.</td>
</tr>
</tbody>
</table>

**Table 4.1 Factors and impact on use**

(Source: http://www.acornlive.com/downloads/pdf/P3_Revision_Summaries.pdf)

When significant fluctuations or unexpected relationships are identified that are inconsistent with other relevant information or that deviate from predicted patterns, auditors should investigate and obtain adequate explanations and appropriate corroborative evidence. Auditors need to obtain sufficient appropriate audit evidence that the information being used for analytical procedures is reliable.
Summary

- Board of directors and management play an important role in any company.
- The focus of the Turnbull Report (1999) is always on the review of internal controls and it has also become a part of the Combined Code.
- Conformance, compliance and efficiency focus on the administration of decisions.
- Processes and procedures should be regularly reviewed.
- Audit programs and procedures should be drawn up ensuring effective coverage of financial, management, operational and compliance issues.
- The board must identify the key risk areas and key performance indicators of the business and continually monitor and compare these to improve the business processes and help safeguard against any impact by competitors.
- Benchmarking systems and programs can be costly and time consuming.
- The diversity and complexity of information can ‘overload’ management, e.g., so much information; management cannot see the wood through the trees.
- Keeping staff motivated, e.g., staff can be criticised and once they exceed standards the standard is normally raised.
- The board should review the performance of management in dealing with internal controls and risk management systems.
- Internal audit is seen as independent from management who are devising and implementing the internal controls, and should be able to provide advice on internal controls both to management and the board.
- Tests are obtaining audit evidence about the effective operation of the accounting and internal control systems.
- Deviations should be recorded and investigated regardless of the amount involved and then assess whether deviations are isolated departures or indicate existence of errors in accounting records.
- Systems based audit is useful as it will help to identify risks within the processes in an organisation and review how adequate the controls are which mitigate these risks.
- Substantive tests or transactions based auditing is to obtain audit evidence to detect material misstatements in the financial statements.
- Internal auditors should plan the audit work so as to perform the audit in an effective manner.
- An item can be considered material if its omission would reasonably influence the decisions of an addressee of the report, a misstatement is material if it would have a similar influence.

References

- *Chapter 5 Audit Process*. [Video online] Available at: <https://www.youtube.com/watch?v=Yyb-hUYd2cA> [Accessed 3 September 2013].
- *6 The Audit Process*. [Video online] Available at: <https://www.youtube.com/watch?v=1yo3GyvZi9Q> [Accessed 3 September 2013].

Recommended Reading

Self Assessment

1. The focus of the __________ Report (1999) is always on the review of internal controls and it has also become part of the Combined Code.
   a. Turnbull
   b. Truncate
   c. Review
   d. Combined

2. How many types of benchmarking are there?
   a. Two
   b. Four
   c. Six
   d. Five

3. Match the following

<table>
<thead>
<tr>
<th>1. Internal benchmarking</th>
<th>A. Compare an internal function to ‘the best’ but not necessarily an organisation in the same industry.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Best practice or functional benchmarking</td>
<td>B. Hospital or healthcare services are compared to that of rival ‘competition’ in the same industry.</td>
</tr>
<tr>
<td>3. Competitive benchmarking</td>
<td>C. Compare an internal function to ‘the best internally’ within the same organisation.</td>
</tr>
<tr>
<td>4. Strategic benchmarking</td>
<td>D. Comparison in terms of an organisations ‘strategic choices’ made to the most successful market leader.</td>
</tr>
</tbody>
</table>

   a. 1-B, 2-D, 3-C, 4-A
   b. 1-D, 2-C, 3-A, 4-B
   c. 1-A, 2-B, 3-D, 4-C
   d. 1-C, 2-A, 3-B, 4-D

4. Which of the following statement is false?
   a. Gain senior management commitment to establish benchmarking as a process with the organisation and educate staff and stakeholders about the demerits.
   b. Undertake the process of benchmarking, e.g., test, measure, observe, experiment or investigate.
   c. Implement improvement, e.g., new programs, processes and procedures.
   d. Monitor and repeat regularly to discourage complacency, follow up improvements implemented to ensure the expected benefits are realised.

5. __________ controls comprise the control environment and control procedures.
   a. External
   b. Internal
   c. Low
   d. High
6. ________ risk obtains understanding of the accounting and internal control systems.
   a. Inherent
   b. Control
   c. Audit
   d. Detection

7. Which one of the following statement is true?
   a. It is inadequate to plan the audit and develop effective audit approach.
   b. Inherent risk misstatement either individually or when aggregated with misstatement in other balances or classes, irrespective of related internal controls.
   c. That material statement could occur and be prevented, or detected on a timely basis, by the accounting and internal control systems.
   d. This is the risk that the auditors’ substantive procedures do detect a material statement in an account balance or class of transactions.

8. Processes and procedures should be ____________ reviewed.
   a. monthly
   b. weekly
   c. regularly
   d. rarely

9. Keeping staff ____________, e.g., staff can be criticised and once they exceed standards the standard is normally raised.
   a. motivated
   b. demotivated
   c. uninspired
   d. focussed

10. __________ tests or transactions based auditing is to obtain audit evidence to detect material misstatements in the financial statements.
    a. Control
    b. Substantive
    c. Direct
    d. Indirect
Chapter V
Audit under Computerised Information System (CIS) Environment

Aim
The aim of this chapter is to:

• introduce audit in a CIS environment
• explain scope of audit in a CIS environment
• explicate impact of changes on business processes

Objectives
The objectives of this chapter are to:

• enlist types of computer systems
• elucidate audit approach in a CIS environment
• define effect of computers on internal controls

Learning outcome
At the end of this chapter, you will be able to:

• identify effects of computers on auditing
• understand internal controls in a CIS environment
• describe internal control requirement under CIS environment
5.1 Introduction

Today’s business world has revolutionary influence of Information Technology on it. It has dramatically changed the manner in which the business is conducted today. Computerisation has a significant effect on organisation control, flow of document information processing and so on. Auditing in a CIS environment even though has not changed the fundamental nature of auditing; it has definitely caused substantial changes in the method of evidence collection and evaluation.

5.2 Scope of Audit in a CIS Environment

Impact of computerisation on audit approach needs consideration of various factors. These factors are as follows:

- **High speed**: In a CIS environment is very useful. It can generate information very quickly. Complex reports can also be generated in a very short period of time in specific report format for audit purposes. This cut down the time and enables the auditor to extend their analytical review for under coverage with high speed of operation as well as their substantive procedures for collection of more evidence in support of their judgment.

- **Low clerical error**: Computerised operation being a systematic and sequential programmed course of action the changes of commission of error is considerably reduced. Clerical error is highly minimised.

- **Concentration of duties**: Manual environment needs deploying of separate individuals for carrying out the verification process by the auditor whereas in CIS environment, the traditional approach does not apply in many cases. The reason for this is as computer programs perform more than one set of activities at a time the concentration duties of several personnel get involved in the work.

- **Shifting of internal control base**: Application systems development control: Systems development control should be designed to provide reasonable assurance in such a manner that they are developed in an authorised and well-organised manner, to establish control, over the following things:
  - testing, conversion, implementation, and documentation of new revised system
  - changes to application system
  - access to system documentation
  - acquisition of application system from third parties

- **Systems software control**: Systems software controls are designed to provide reasonable assurance that system software is acquired or developed in an authorised and well-organised manner including the following things:
  - authorisation, approval testing, implementation and documentation of new system software systems software modifications
  - putting restriction of access to system software and documentation to authorised personnel

- **Disappearance of manual reasonableness**: The shift from traditional manual information processing environment to computerised information systems environment needs a detailed analysis of the physical system for transformation into a logical platform. In creating such logical models many stages required under manual operations are either deleted or managed to create a focused computer system. In such creative effort, the manual reasonableness may be missing.

- **Impact of poor system**: If system analysis and designs falls short of expected standard of performance, a computerised information system environment may do more harm to integrated business operation than good. Thus, care has to be taken in adopting manual operations switchover to computerised operations for ensuring performance quality standards.

- **Exception reporting**: This is a part of Management information system. Exception Reporting is a departure from straight reporting of all variables. Here the value of a variable is only reported if it lies outside some pre-determined normal range. This form of reporting and analysis is familiar to the accountant. The main strength of exception reporting lies in its recognition that to be effective information must be selectivity provided.

- **Man-machine interface/human-computer interaction**: Man-machine interface ensures maximum effectiveness of the information system. Organisation concentrated on presenting information that is required by the user and to present that information in the most uncluttered way. It is required to determine what information was necessary to achieve through a careful analysis of the job or task for which the user needed the information.
5.3 Impact of Changes on Business Processes

The impact of changes on accounting processes due to the shift to electronic medium fall under two types of changes. They are called primary changes and recent changes.

5.3.1 Primary Changes

Primary changes are further classified into various stages. These stages are explained in detail below.

- Process of recording transactions: When accounting processes are computerised under CIS environment, the process of recording transaction undergoes a major change. It is not essential to follow the order of recording transaction from basic document to prime books and finally to principal book because it is observed in manual system itself. In many cases all the three processes Prime book of Entry - Ledger - Final accounts (Balance Sheet and Profit and Loss Account) are carried on simultaneously.

- From of accounting records: Mechanisation often results in the abandonment in whole or sometimes it can be in part of the primary records. Punch card installation or electronic data processor changes the form of both intermediate and ultimate records. It is much more radical than manual records.

- Use of loose-leaf stationeries: Bound hand written records as used in manual accounting processes are replaced by loose-leaf machine written records in electronic medium. Traditional records are being replaced by the magnetic tapes, floppy disks, diskettes, printouts in a computerised information system. The proper control over such records is necessary to prevent their unauthorised use, destruction or substitution.

- Use of accounting code: In computerised information systems, alpha-numeric codes are extensively used to represent names and description. The accountants as well as the auditors have to get themselves familiarised with the use of such codes which initially may pose considerable problems in understanding the various transactions.

- Absence of link between transactions: In a computerised information system environment, there may be an inadequacy or even total absence of cross-reference between the basic documents, primary records and may be the principal records. It is quite difficult to trace a transaction from start to finish there by the auditors may find it complicated in such case they prefer to lose audit trials.

5.3.2 Recent Changes

Auditors must be alert to the growth and development in the field of information technology because this field is very a fast growing technology. Therefore, auditors should take pre-emptive action in upgrading their knowledge. A few cases of the recent changes which auditors should address while discharging their responsibilities in such environment are as follows:

- Mainframes are substituted with mini/micro users.

- There is a shift from proprietary operating system to more universal ones like UNIX, LINUX, Programming in ‘C’ etc.

- Relational Data Base Management (RDBMS) are in bulk use.

- The methodology adopted for systems development is becoming crucial and CASE (Computer Aided Software Engineering) tools are being used by many organisation.

- End user computing is on the increase resulting in decentralised data processing.

- The need for data communication and networking is increasing.

- Common business documents are getting replaced by paperless electronic data interface (EDI).

- Conventional data entry giving way to scanner, digitised image processes, voice recognition system etc.
5.4 Advanced Auditing and Professional Ethics

The impact of all kinds of changes on auditing may be summarised as follows:

- Wide-spread end-user computing may result in unintentional errors into systems due to incompetent handling; also coordinated program modification may not be possible.
- Improper use of decision support system can have serious consequence; also their underlying assumption must be clearly documented.
- Usage of sophisticated audit software is necessary.
- Auditor’s non-participation at System Development Life Cycle State (SDLC) pretense considerable problem in understanding the operational controls.
- Data communication and net working can introduce new audit risk.
- The move toward paperless EDI would eliminate much of the traditional audit trail radically changing the nature of audit trails.

5.5 Audit Approach in a CIS Environment

Based on the knowledge and expertise of auditors in handling computerised data, the audit approach in a CIS environment could be either of the following.

5.5.1 A Black-box approach

The Auditor concentrates on input and output and ignores the specifics of how computer process the data or transactions in the Black box approach or Auditing around the computer. If input matches the output, the auditor assumes that the processing of transaction/data must have been correct.

Consider an example, suppose in payroll application, the auditor has two choices. Auditor might first examine selected time cards for hours worked and employee earning cards for rates and then trace these to the payroll summary output and at last he can compare time requires, rates and extensions for the project. The comparison of inputs and outputs may be done manually with the assistance of the computer. The computer assisted approach has the advantage of permitting the auditor to make more comparisons than would be possible, if it is done manually.

Auditing around the computer has the advantage of ease of comprehension as the tracing of documents to output does not require any in-depth study of application program. A main drawback, however, is that the auditor without having directly tested the control, cannot make assertions about the underlying process. Moreover, in some of the more complex computer systems intermediate printout may not be available for making the needed comparisons.
5.5.2 A White-box approach

The processes and controls surrounding the subject are subject to audit as well as the processing controls operating over auditing through the computer process are investigated. Computer audit software may be used in order to help the auditor to gain access to these processes. These packages may usually include:

- Some interactive enquiry facilities to interrogate files.
- Facilities which can analyse computer security logs for unusual usage of the computer.
- The ability to compare source and object (compiled) program codes and it helps in detecting dissimilarities.
- The facility of executing and observing the computer treatment of “live transaction” by moving through the processing as it occurs.
- The generation of test data.
- The generation of aids showing the logs of application programs, the actual controls and the higher level control will be evaluated and then subjected to compliance testing and if needed, substantive testing before an audit report is produced.

![Diagram of Auditing Through The Computer]

**Fig. 5.2 Auditing through the computer**

It is obvious, that to follow auditing through the computer approach the auditor needs to have sufficient knowledge of computers to plan, direct-supervise and review the work performed. The areas covered in an audit focus on the following controls:

- Input controls
- Processing control
- Storage control
- Output control
- Data transmission control

Adequate controls over the prevention of unauthorised access to the computer and the computerised database; auditor should be satisfied with this fact. The auditors task also involve consideration of the separation of functions between staff involves in transaction processing and the computerised system and ensuring that adequate supervision of personnel is administered.
The process of auditing is not a straightforward flow of work from start to finish to be completed by satisfying oneself against a standard checklist or a list of questions. It involves exposure, experiences and application of knowledge and expertise to differing circumstances. Two information systems cannot be same. The auditors need not only have adequacy on knowledge regarding information requirement and computer data security they must also get exposed to system analysis and design so as to facilitate post implementation audit, from the view point of analysis of computerised information system.

5.6 Types of Computer Systems

Accounting and other type of information processing has a large variety of computer systems applicable to accounting and other type of information processing. The various types of controls for its efficient and effective functioning get affected by the nature and type of system. Computer system may be broadly classified as under:

5.6.1 Systems configuration

System configuration is a vast area and is classified as under:

Large system computers

The processing task of multiple users is performed on a single centralised computer, in large system computers. It shows that all inputs move directly from the terminal to central processors and after processing goes back to users from central processors. All the terminals in these systems were called ‘dumb terminals’ as these terminals were not capable of processing data on their own and casually serve only as input/output terminals. With time, these systems have become more efficient and sophisticated. In many cases dumb terminals have given way to intelligent terminals. It allows data processing at local levels.

Stand alone personal computers

A stand alone system is one that is not connected to or does not communicate with another computer system. Computing is done by an individual at a time. All input data and its processing takes place on the machine itself. Many small businesses rely on personal computers for all their accounting functions.

Network computing system

A network is a group of interconnected system sharing services and interacting by a shared communication links. All networks have something to share, a transmission medium and rules for communication. Network shares hardware and software resources of computing system. Hardware resources include following terms:

- Client server: A server in a network is dedicated to perform specific tasks to support other computers which are on the network. Some common types of servers are listed below:
  - File server: These are the network applications which store, retrieve and move data.
  - Data base server: Most of the data bases are client server based. Database servers provide a powerful facility to process data.
  - Message server: Message server provide a variety of communication methods and takes the form of graphics, digitised audio/video etc.
  - Print server: It manages print services on the network.

Software resource sharing provides a facility to share information in the organisation. The networks can also be classified on the basis of areas covered. Software resources include:

Local area network

In a local area network (LAN), two or more computers located within a small distinct area like room, office or campuses are connected through cables. In this case one of the computers acts as the server; it stores the program and data files centrally. These programs and data files can be accessed by the other computers forming part of the LAN. LAN provides the additional advantage like sharing programs, data and physical resources such as hard disks peripherals.
Wide area network
Wide area networks are the networks that employ public telecommunications facilities to provide users with access to the resources of centrally located computers. The public switched telephone network, high speed fiber optic cable, radio links or the internet are all used by a WAN. When a LAN extends in the metropolitan area using the WAN technology, it is called Metropolitan Area Network (MAN). WAN uses modem to connect computers over telephone lines (PSTN) PSTN system transfer analog signals. This is the reason why public telephone system is not appropriate to connect computers. Modems are used to convert analog signals into digital and vice versa.

Distributed data processing
Distributed data processing covers many varieties of a computer system. Its hardware is located at least two geographically distinct sites which are connected electronically by telecommunications where processing / data storage occur at two or more than one sites. The communication link is used by the decentralised units and the main computer to communicate. A more integrated connection occurs with ‘cooperative processing where processing is handled by two cooperating geographically distinct processors. One processor sends the output of its processing to another for completion. The system becomes more complex, where operating systems of both machines are different. Cooperative operating system may be required under such situation.

Electronic data interchange (EDI)
The transfer of electronic data from one organisations computer system to another’s, the data being structured in a commonly agreed format so that it is directly usable by the receiving organisation computer system is known as EDI. EDI may be introduced where a group of organisations wish to ensure that electronic transactions are passed between one another. For involving the data exchanges EDI groups require EDI services. In more than merely the transmission of the data these are often provided by a third party. By providing these services the third party adds value to the data transmission and is thus called value added network (VAN). The following benefits occur under the EDI systems:

• The speed of an inter-organisational transaction processing is minimised.
• The paperwork implicated in transaction processing is eliminated.
• The costs of transaction processing are reduced, according to the need for human interpretation and processing is removed.
• Reduced human involvement reduces error.

5.6.2 Processing system
Transaction processing systems include various other systems. All are explained in detail below.

Batch processing
Under batch processing a large volume of homologous transactions are aggregated and processed periodically. The four processes in batch processing are as follows:

• Occurrence of transaction: Source document records the occurrence of business events.
• Recorded in a Transaction file: The information is extracted from the source document; for this a batch of source is periodically transferred to the data entry operator and enter it into the computer format. Data entry is typically done off line. The computerised format is the transaction file to be processed in the system. The records entered are confirmed with the source document after the data entry is done. Once the records are checked, the source documents are stored separately for future reference.
• Updating the Master file: The master files are updated after all the data is entered in the system and it is processed and summarised.
• Generation of output: After processing and updating the master file, the report, as required is periodically generated. Batch processing systems are used for processing large volumes of repetitive transactions where control considerations and efficient utilisation of computing capacity are important.
**Online processing system**

Online processing refers to processing of individual transactions as they occur from their point of origin as opposed to accumulating them into batches. This is possible by direct access devices such as magnetic disk and number of terminals connected to and controlled by central processors. In this way, various departments in a company can be connected to the processor by cables. Inquiries are handled by the online processing system, transaction processing and file updating, etc. Online processing takes care of the records whether they are in updated status or not at any time. However, in batch processing it is different. Also, the online processing is comparatively costly.

**Interactive processing**

Under interactive processing mode, a continuous dialogue exists between the user and the computer. This process is also called ‘transaction driven’ processing as transactions dealt with completely on an individual basis through all the relevant processing operations before dealing with the next transaction occur and enquiries to be dealt with on an immediate response basis.

**Online real time processing**

The term ‘Real Time’ refers to the technique of updating files with transaction data immediately after the occurrence of the event. Real time systems are basically on-line system with one speciality in enquiry processing. The response of the system to the enquiry itself is used to control the activity. The response of a real time system is one type of feedback control system. The response time differs from one activity to another. Real time system usually operates in multi-processing and multi-programming. This increases availability as well as reliability of the system. In real time systems CPU’s should possess the capability of ‘Program Interrupts’. These play temporary stoppage of halts in the execution of a program and the more urgent message gets handled on priority. Some computer systems are designed to operate in both batch and real time modes and some are dedicated to real time operations it also helps them in serving as stand by units to each other.

**Time sharing**

Time sharing allows access to a CPU and files through many remote terminals. Multiprogramming is the method of implementing time shared operations. In transaction processing, time sharing occurs when a computer processes transactions of more than one entity.

**Service bureau**

A service bureau is a company that processes transaction for other entities. Such units may handle the computer processing for small companies that individually do not have sufficient transactions to justify the acquisition of a computer.

Advanced processing system further includes decision support system; we will explore the system in detail below:

**Decision support system**

A system solving provided tools to managers to assist them in soloing semi-structured and an unstructured problem is known as decision support system. A DSS is intended to provide managers with a set of capabilities that enables them to generate the information that is required by them but it is not intended to make decisions for managers. A DSS supports the human decision making process, and do not provide a means to replace it. The decision-support system are characterised by the following factors:

- support semi-structured or unstructured decision making
- flexible enough to respond to the changing needs of decision makers
- easy to operate
A decision-support system has four basic components:

- The users: Users represent managers at any given level of authority in the organisation.
- Data bases: Data base contains both routine and non-routine data from both internal and external sources.
- Planning language: Spread sheets/special purpose planning languages, SAS, SPSS, Minilab, etc are included in general purpose planning languages.
- Model base: Model base is the ‘Brain’ of the decision support system because it performs data manipulations and computations with the data provided by the user and data base.

**Expert System**

An expert system is a computerised information system that allows non experts to make decision comparable to that of an expert. Expert systems are used for complex or ill structured tasks that require experience and special knowledge in specific subject areas. An expert system typically contains:

- Knowledge base: Data, knowledge, relationships, rules of thumb to and decision rules used by experts to solve a particular type of problem are included by the knowledge base. A knowledge base is the computer equivalent of all the knowledge together. Knowledge base is created by an expert or a group of experts develop through years of experience in their field.
- Inference engine: This program contains the logic and reasoning mechanisms that stimulate the expert system logic process and deliver advice. It uses data obtained from both the knowledge base and the user to make associations and inference, forms its conclusion and recommends a course of action.
- Use interface: This program allows the user to design, create, update, use and communicate with the expert system.
- Explanation facility: This facility provides the user with an explanation of the logic the expert system use to arrive.
- Knowledge acquisition Facility: Building a knowledge base (also called knowledge engineering), involves both a human expert and a knowledge engineer. The knowledge engineer is responsible for extracting an individual’s expertise and using the knowledge acquisition facility to enter into the knowledge base.

**Integrated File System**

These systems update many files simultaneously as transaction is processed. Processing of a sales order updates the accounts receivable control accounts and the related subsidiary ledger is also updated and the sales control and sales details are also posted as the sales order is processed. Integrated data base system contains a set of interrelated master files that are integrated in order to reduce data redundancy. The software used to control input processing and output is referred to as Data Based Management System (DBMS) which handles the storage, retrieval, updating and maintenance of the data in the data base.

Integrated files are most commonly associated with OLRT (on-line real time) system and pose the greatest challenge to the Auditor’s. Controls within these systems are harder to test and assess due to the danger of file destruction. Files may be physically stored on disk in the following way:

- ‘Sequentially’ records are physically ordered by some field (e.g., employee number).
- ‘Randomly’ records are stored at a physical address computed by an algorithm working on a field value.
- ‘Indexed’ records are physically stored randomly with a sequentially ordered index field (e.g. by customer) and a pointer to the physical location of each record. ‘Indexed Sequential’ records are physically stored sequentially ordered by some field together with an index which provides access by some possibly other field.

If files are required to be processed sequentially, then they may be stored sequentially. The sequential update of an employee master file by time sheet data is an example. However, if individuals records are required to be accessed from time to time by some field e.g. employee name, then one of the other storage method may be used.
5.7 Effect of Computers on Internal Controls

Internal control system include separation of duties, delegation of authority and responsibility, a system of authorisation, adequate documents and records, physical control over assets and records, management supervision, independent checks on performance and periodic reconciliation of assets with records. In CIS environment, all these components must exist but computers affects the implementation of these internal controls in many ways. Some of the effects are as under:

- **Separation of duties:** In a manual system, different persons are responsible for carrying out function like initiating, recording of transaction, safeguarding of assets, does not always apply in a computer system. For example, in a computer system, a program may carry out reconciliation of vendor invoice against a receipt document and also prepares a cheque payable to creditors. Such operation through a program will be considered as incompatible functions in a manual system. In minicomputer and microcomputer environments, separation of incompatible function could be even more difficult. Some such forms, allows, users to change programs and data entry without providing a record of these changes. Thus, it becomes difficult to determine whether incompatible function have been performed by system users.

- **Delegation of authority and responsibility:** A structured authority and responsibility is an essential control within manual and computer environment. In a computer system however, a clean line of authority and responsibility might be difficult to establish because some resources are shared among multiple users. For instance, one objective of using a data base management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data, when multiple users have access to the same data and the integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organisation identified a single user as the owner of the data.

- **Competent and trustworthy personnel:** Skilled, competent, well-trained and experienced information system personnel have been in short supply. Since, substantial power is often vested in the person responsible for the computer information system development, implementation, operation and maintenance within the organisation, competent and trustworthy personnel is very much in demand. Unfortunately, the non availability of competent personnel, forced many organisation to compromise on their choice of staff. Moreover, it is not always easy for organisation to assess the competence and integrity of their system staff. High turnover among those staff has been the norm. Some information systems personnel lack a well developed sense of ethics and some enjoy in subverting controls.

- **System of authorisation:** Management authorisation of transaction may be either:
  - General authorisation to establish policies for the organisation
  - Specific authorisation applying to individual transactions.

In manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, authorisation procedures often are embedded within a computer program. In a computer system, it is also more difficult to assess whether the authority assigned to individual persons is constant with managements policies. Thus, in evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of the programme processing

- **Adequate documents and records:** In a manual system, adequate documents and records are required to provide an audit trail of activities within the system. In computer system, document support might not be necessary to initiate, execute and records some transaction. The task of a visible audit trail is not a problem for auditors; provided the systems have been designed to maintain a record of all events and that they are easily accessible. In well-designed computer systems, audit trails are more extensive than those maintained in manual systems unfortunately not all computer systems are well designed. This creates a serious control problem.

- **Physical control over assets and records:** Physical access to assets and records is critical in both manual systems and computer system. In a computer system the information system assets and records may be concentrated at a single site. The concentration of information systems assets and record also increases the losses that can arise from computer abuse or disaster. If the organisation does not have another suitable backup, it might be unable to continue operations.
Adequate management supervision: In a computer system, supervision of employee might have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and inquiring computer system also make the activities of employees less visible to management. Since many activities are electronically controlled, managers must periodically access the audit trial of employee activities and examine it for unauthorised actions.

Independent checks on performance: Checks by an independent person help to detect any errors or irregularities. In a computer system, if a program code is authorised accurate, and complete the system will always follow the laid down procedures in absence of other type of failures like hardware or systems software failure. Thus, independent checks on the performance of programs often have little value. Instead, the control emphasis shifts to ensuring the veracity of programme code. Auditors must now evaluate the controls established for program development, modification operation and maintenance.

Comparing recorded accountability with assets: In a manual system, independent staff prepares the basic data used for comparison purposes. In a computer system, software is used to prepare this data. If unauthorised modifications occur to the program or the data files that the program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

5.8 Effects of Computers on Auditing

The objective of auditing, do not undergo a sea change in a CIS environment. Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:

Changes to evidence collection
Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:

- accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system
- system development control include procedures for testing programs that again are not necessary in manual control

Since, hardware and software develop quite rapidly, understanding the control technology is not easy. With the increasing use of data communication for data transfer, research is focussed on cryptographic controls to protect the privacy of data. Unless auditor’s keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence. Though generalised audit softwares are available the development of these tools cannot be relied upon due to lack of information. Often auditors are forced to compromise in some way when performing the evidence collection.

Changes to evidence evaluation
With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system. Auditors need to understand:

- whether a control is functioning reliably or multi functioning
- traceability of control strength and weakness through the system

In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.
Consequences of errors in a computer system are a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

5.9 Internal Controls in a CIS Environment

Internal control is an essential prerequisite for efficient and effective management of any organisation. Basically, they are the policies and procedure adopted by a management to achieve the entity’s specific objectives like, physical verification of assets, periodic review and reconciliation of accounts, specific control on computer generated data etc. An internal control is a CIS system depends on the same principal as that of manual system. Thus, the plan of organisation, delegation of powers, system authorisation, distribution of duties etc., are determined on similar consideration as in a manual system. However, in a CIS environment, due to difference in approach there is various other types of controls which are quite specific to CIS environment.

In setting up an internal control system in a CIS environment, the overall CIS operation need to be broken down into defined subsystem and controls established accordingly, addressing each function separately so that auditors can place reliance on them. The basic components that can be identified in a CIS environment are:

- Hardware (CPU, Monitor, Printers etc.)
- Software (Operating system, application programs, Data base management system etc.)
- People (Data entry operator, CIS organisation, end users)
- Transmission media

Once components have been identified, auditors must evaluate their reliability with respect to each type of error or irregularity that might occur. The reliability of a component is a function of the controls that act on the component. A control is stated to be a set of activities designed to prevent, detect or correct errors or irregularities that affect the reliability of the components. The set of all control activities performed in a system constitutes the control subsystem within a system. Its function is to establish execute modify and maintain control activities so that the reliability of the system in maintained at an acceptable level. In a computer system many different types of controls are used to enhance component reliability. Major classes of control that the auditor must evaluate are:

- Authenticity controls: Authenticity control is exercised to verify the identity of the individuals or process involved in a system (e.g., password control, personal identification numbers, and digital signatures).
- Accuracy control: Accuracy control ensures the correctness of data and processes in a system. (e.g., program validation check that a numeric field contains only numeric, overflow checks, control totals, hash total etc.).
- Completeness control: Completeness control attempt to ensure that no data is missing and that all processing is carried through to its proper conclusion (e.g., program validation check, sequence check etc.).
- Redundancy control: Redundancy controls attempts to ensure that a data is processed only once (e.g., batch cancellation stamp, circulating error files etc.).
- Privacy controls: Privacy controls ensure that data is protected from inadvertent or unauthorised disclosure (e.g., cryptograph, data compaction, inference control etc.).
- Audit trail controls: Audit trail control ensure traceability of all events occurred in a system. This record is needed to answer queries, fulfil statutory requirements, minimise irregularities, detect the consequences of error etc. The accounting audit trail shows the source and nature of data and process that update the database. The operations audit trail maintains a record of attempted or actual resource consumption within a system.
- Existence controls: Existence controls attempt to ensure the ongoing avail ability of all system resources (e.g., database dump and logs for recovery purposes duplicate hardware, preventive maintenance, check point and restart control).
• Asset safeguarding controls: Asset safeguarding control attempt to ensure that all resources within a system are protected from destruction or corruption (e.g. physical barriers, libraries etc.).
• Effectiveness controls: Effectiveness control attempt to ensure that systems achieve their goals (e.g., monitoring of user satisfaction, post audits, periodic cost benefit analysis, etc.).
• Efficiency controls: Efficiency controls attempt to ensure that a system uses minimum resources to achieve its goals.

5.10 Control Attributes by the Auditors
In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control. Some of the attributes are:
• Whether the control is in place and is functioning as desired generality versus specificity of the control with respect to the various types of errors and irregularities that might occur. General control inhibit the effect of a wide variety of errors and irregularities as they are more robust to change controls in the application sub-system which tend to be specific control because component in these sub-system execute activities having less variety.
• Whether the control acts to prevent, detect or correct errors. The auditor focuses on:
  • Preventive controls: Controls which stop errors or irregularities from occurring.
  • Detective controls: Controls which identify errors and irregularities after they occur.
  • Corrective controls: Controls which remove the effects of errors and irregularities after they have been identified.
Auditors expect to see a higher density of preventive controls at the early stages of processing or conversely they expect to see more detective and corrective controls later in system processing.

Multi-component controls are more complex and more error prone but they are usually used to handle complex errors and irregularities.

5.11 Internal Control Requirement under CIS Environment
The requirement of internal control under CIS environment may cover the following aspects:
• Organisation and management control: Controls are designed to establish an organisational frame work for CIS activities including:
  • Policies and procedures relating to control functions.
  • Appropriate segregation of incompatible functions.
• Application system development and maintenance control - Control are designed to provide reasonable assurance that systems are developed and maintained in an authorised and efficient manner, to establish control over:
  • testing, conversion, implementation and documentation of new revised system
  • changes made to application system
  • access to system documentation
  • acquisition of application system from third parties
• Computer operation controls: Designed to control the operation of the system and to provide reasonable assurance that:
  • the systems are used for authorised purposes only
  • access to computer operation is restricted to authorised personnel
  • only authorised programs are to be used
  • processing errors are detected and corrected
System software control: Controls are designed to provide reasonable assurance that system software is acquired or developed in an authorised and efficient manner including:
  - authorisation, approval, testing, implementation and documentation of new system software and system software modification
  - restriction of access to system software and documentation to authorised personnel

Data entry and program control: Designed to provide assurance:
  - an authorisation structure is established over transaction being entered into the system
  - access to data and program is restricted to authorised personnel

Control over input: Control are designed to provide reasonable assurance that:
  - transactions are properly authorised before being processed by the computer
  - transactions are accurately converted into machine readable from and recorded in the computer data files
  - transaction are not lost, added, duplicated or improperly changed
  - incorrect transactions are rejected, corrected and if necessary, resubmitted on a timely basis

Control over processing and computer data files: Controls are designed to provide reasonable assurance that:
  - transactions including system generated transactions are properly processed by the computer
  - transaction are not lost, added duplicated or improperly changed
  - processing errors are identified and corrected on a timely basis

Control over output: It is designed to provide reasonable assurance that:
  - results of processing are accurate
  - access to output is restricted to authorised personnel
  - output is provided to appropriate authorised personnel on a timely basis

Other safeguards: Other safeguards include:
  - Offsite back-up of data and program
  - Recovery procedures for use in the event of theft, loss or intentional or accidental destruction
  - Provision of offsite processing in the event of disaster

5.12 Approaches to Auditing in a CIS Environment

Auditing in a computer information system environment stresses that the overall objective and scope of an audit do not change in a CIS environment. However, the use a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. The auditor should consider the effect of the factor like:
  - the extent of use of computers for preparing accounting information
  - efficacy of internal control over input, processing, analysis and reporting undertaken in the CIS installation
  - the impact of computerisation on the audit trail that could otherwise be expected to exist in a manual system

The approach to auditing in a CIS environment provides for the following:

- Skill and competence: An auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the CIS environment. The auditor should consider whether any specialised CIS skills are needed in the conduct of the audit. If the answer is in affirmative the auditor would seek the assistance of an expert possessing such skills.
- Planning: In regard to planning, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of the data for use in the audit.

The auditor should also obtain an understanding of the accounting and internal control system to plan the audit and to determine the nature, timing and the extent of the audit procedures. Auditors understanding the process would include:
• The computer information systems infrastructure (hardware, operating system(s) and application software used by the entity, including changes therein since last audit, if any).

• The significance and complexity of computerised processing in each significant accounting application. Significance relates to materiality of the financial statement assertions affected by the computerised processing.

• Determination of the organisational structure of the client; CIS activities and the extent of concentration or distribution of computer processing throughout the entity, particularly, as they may affect segregation of duties.

• The auditor needs to determine extent of availability of data by reference to source documents, computer files and other evidential matters. Computer information systems may generate reports that might be useful in performing substantive tests (particularly analytical procedures). The potential for use of CAATS may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of transactions.

• Risk: When the computer information systems are significant the auditor should assess whether it may influence the assessment of inherent and control risks. The nature of the risks and the ICS in CIS environment include the following:
  - Lack of transaction trails: Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly errors embedded in an application’s program logic may be difficult to detect on a timely basis by manual procedures.
  - Uniform processing of transactions: Computer programs processing transactions uniformly, virtually eliminating the occurrence of clerical errors. However, if programming error exists all transactions will be processed incorrectly.
  - Lack of segregation of functions: Many controls become concentrated in a CIS environment allowing data processing of incompatible functions.
  - Potential for errors and irregularities: The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS environment than in manual systems.
  - Initiation or execution of transactions: In a CIS process certain types of transactions are triggered internally by the system, the authorisation for which may not be documented as in manual system. In such cases, management; authorisation of these transactions may be implicit.
  - Dependence of other controls over computer processing: Certain manual control procedures are dependent on computer generated reports and outputs for their effectiveness. In term, the effectiveness and consistency of transaction processing controls are dependent on the effectiveness of general computer information systems controls.
  - Increased management supervision: Computer information can offer management a variety of analytical tools that can enhance the effectiveness of the entire internal control structure.
  - Use of computer-assisted audit techniques: The Auditor may apply general or specialised computer audit techniques and tools in the execution of audit tests.

While evaluating the reliability of the accounting and internal control systems, the auditor would consider whether these systems:

• Ensure that authorised, correct and complete data is made available for processing.

• Provide for timely detection and correction of errors.

• Ensure that the case of interruption in the work of the CIS environment due to power, mechanical or processing failures, and the system restarts without distorting the completion of the entries and records.

• Ensure that accuracy and completeness of output.

• Provide adequate data security against fire and other calamities, wrong processing, frauds etc.

• Prevent unauthorised amendments to the program.

• Provide for safe custody of source code of application software and data files.
Risk assessment

The auditor in accordance with SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment” should make an assessment of inherent and control risk for material financial statement assertions. Risk may result from deficiencies in:

- Program development and maintenance.
- System software support.
- Operations.
- Physical CIS security.
- Control over access to specialised utility programs.

These deficiencies would tend to have a negative impact on all application systems that are processed through the computer. Risk may also increase the potential for errors or fraudulent activities in:

- Specific applications
- Specific data base or master files
- Specific processing activities

As new CIS technologies are emerging for data processing and Clients are adopting the same for building complex computer systems, these may increase risk which needs further consideration.

Documentation

The Auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. In an audit in CIS environment, some of the audit evidence may be in electronic form. The auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.

5.13 Review of Checks and Controls in a CIS Environment

General controls in a CIS environment falls under the three basic control approaches as seen under manual system, i.e. Feedback, feed-forward and preventive control. Apart from the three-fold categorisation computer based information system also required different controls, though the emphasis is on preventive controls. Controls are present over many aspects of the computer system and its surrounding social environment. They operate over data moving into, through and out of the computer to ensure correct, complete and reliable processing and storage. There are other controls present over staff, staff involvement with the computer and access to data. Further controls are effective at preventing deterioration or collapse of the entire computing function.

Erroneous data processing by a computer system is likely to be the result of incorrect data input. This is the major point at which the human interfaces with the machine and it is here where important controls are placed. The Review Process consists of:

- Organisation structure/control: CIS function in an organisation need to be so organised that different groups are formed to perform different duties in a large CIS installation. Some of the typical function that must be performed by select group includes:
  - Data administrator: Generates the data requirements of the users of information system services: formulates data policies, plans the evaluation of the corporate data bases, and maintains data documentation.
  - Database administrator: Responsible for the operational efficiency of corporate database, assist users to use database better.
  - System analyst: Manages information requirement for new and existing applications, designs information systems architectures to meet these requirements, facilitates implementation of information systems, writing procedures and users documentation.
  - System programmers: Maintains and enhances operating systems software, network software, library software, and utility software, provides when unusual systems failure occurs.
  - Application programmer: Designs programs to meet information requirements, codes, tests and debugs programs, documents programs, modify program to remove errors, improve efficiency.
• Operation specialist: Plans and control day-to-day operations, monitors and improves operational efficiency along with capacity planning.

• Librarian: Maintains library of magnetic media and documentation. Auditors should be concerned about two matters:
  - Responsibilities of each job position must be clear; and incumbents must fully understand their duties, authority and responsibilities.
  - The jobs performed within the information system function should maintain separation of duties to the extent possible. Without separation of duties, errors and irregularities might remain undetected.

• Documentation control: Systems and programs as well as modifications, must be adequately documented and properly approved before being used. Documentation ordinarily assumes the following form:
  - A system flowchart
  - A program flowchart
  - Program change
  - Operator instructions
  - Program description (explaining the purpose for each part of the program)
  - Adequate documentation evidencing approval of changes minimises the probability of unauthorised system and program changes that could result in loss of control and decreased reliability of financial data

• Access control: Access controls are usually aimed at for preventing unauthorised access. The controls may seek to prevent persons who are authorised for access from accessing restricted data and program, as well as preventing unauthorised persons from gaining access to the system as a whole.
  - Segregation controls
    - Access to program documentation should be limited to those persons who require it in the performance of their duties.
    - Access to data files and programs should be limited to those individuals authorised to process data.
    - Access to computer hardware should be limited to authorised individuals (e.g. Computer operators).
  - Limited physical access to the computer facility
    - The physical facilities that hold the computer equipment, files and documentation should have controls to limit access only to authorised individuals.
    - Types of controls may include, using a guard, automated key cards, manual key locks, and new access devices like, fingerprints, palm prints, or other biometric devices.
  - Visitor entry logs: Entry logs should be used to determine and document those who have had access to the area.
  - Hardware and software access controls: Access control software like ‘user identification’ may be used. User identification is a frequently used control and is a combination of a unique identification code and a confidential password.
  - Call back: It is a specialised form of user identification in which the user dials the system, identifies him and is disconnected from the system. Then, either an individual manually finds the authorised telephone number or the system automatically finds the authorised telephone number of the individual and finally the user is called back.
  - Encryption: In encryption data is encoded when stored in computer files / and or before transmission to or from remote locations. This coding protects data because to use the data unauthorised users must not only obtain access, but must also decrypt the data i.e., decode it from encoded form.
  - Computer application controls: Programmed application controls apply to specific application rather than multiple applications.
    - These controls operate to assure the proper input and processing of data. The input steps convert’s human readable data into computer readable form. All CIS application is classified under three heads: Input, Processing and output.
Input controls: Input into the CIS system should be properly authorised and approved. The system should verify all significant data fields used to record information i.e., should perform editing of the data. Conversion of data into machine readable form should be controlled and verified for accuracy. For validation of input controls, the following procedure can be applied:

- **Pre-printed form:** All constant information be printed on a source document. For example, if only limited number of responses to a question is considered appropriate then preprint the responses and have the user tick or circle the correct responses deleting those that are inappropriate.

- **Check digit:** Errors made in transcribing and keying data can have serious consequences. One control used to guard against these types of errors is a ‘Check Digit’. A Check digit is a redundant digit (s) added to a code that enables the accuracy of other characters in the code to be checked. The check digit can act as a prefix or suffix character or it can be placed somewhere in the middle of the code. When the code is entered, a program recalculates the check digit to determine whether the entered check digit and the calculated check digit are the same. If they are the same, the code is most likely to be correct.

**Calculation of check digit**

A simple way is to add the digits in a number and assign the result as a suffix.

Example: The number is 2148 the check digit is \(2+1+4+8=15\) i.e., 5 (dropping tens digit). The code is 21485. However, this does not protect transposition error, like 2814. The incorrect code will still produce the correct check digit.

This problem can be overcome by Module -11 test. The Calculation steps are as under:

1. The desired number = 2148.
2. Make weighed average = \(2 \times 5 + 1 \times 4 + 4 \times 3 + 8 \times 2 = 42\)
3. Divide by Modules 11 = \(42/11 = 3\) with remainder 9
4. Subtract the remainder from the modules = \(11 - 9 = 2\) (check digit)
5. Check digit is added as a suffix = 21482.

The check digit can be recalculated for verification as under:

1. The encoded number = 21482
2. Weighted average = \((2 \times 1) + (8 \times 2) + (4 \times 3) + (1 \times 4) + (2 \times 5) = 44\) .
3. Division by the modules = \(44/11 = 4\) with no remainder.

If the remainder is zero, there is a high probability that the code is correct.

- **Completeness totals:** To input data erroneously is one type error. To leave out or lose data completely is another type of error against which controls are provided.
  - Batch control totals: The transactions are collected together in batches of say, 50 transactions. A total of all the data value of some important field is made. For example, if a batch of invoices is to be imputed a total of all the invoices amounts might be calculated manually. The control total is then compared with a computer generated control total, after input of batch transaction. A difference indicates either a lost transaction or the input of an incorrect invoice total. The method is not fool proof as compensating errors is possible.
  - Batch hash total: The idea is similar to control totals except that Hash totals are meaningless totals prepared purely for control purposes. The total of all customer account numbers in a batch is meaningless but may be used for control by comparing it with computer generated hash totals.
  - Batch record totals: Account is taken of the number of transactions and this is compared with the record count produced by the computer at the end of the batch.
  - Sequence checks: Documents may be pre-numbered sequentially before entry and at a later stage the computer will perform a sequence check and display any missing number.
• Reasonableness checks: These are sophisticated forms of limit checks. An example might be a check on an electricity meter reading. The check might consist of subtracting the last reading recorded from the current reading and comparing this with the average usage for that quarter. If the reading differs by a given percentage then it is investigated before processing.

• Field checks: The following types of field checks may be applied:
  • Missing data/blank: Is there any missing data in the field? If a code should contain 2 hyphens, though they might be in a variable position, can only one be detected? Does the field contain blanks when data always should be present.
  • Alphabetic/Numeric: Does a field that should contain only alphabetic or numeric contain alphanumeric characters?
  • Range: Does the data for a field fall within its allowable value range?
  • Master reference: If the master file can be referenced at the same time input data is read, is there a master file match for the key field?
  • Size: If variable-length fields are used and a set of permissible sizes is defined does the field delimiter show the field to be one of these valid sizes?
  • Format mask: Data entered into a field might have to conform to a particular format, like ‘yy mm dd’

• Record checks: The following types of record checks can be applied:
  • Reasonableness: Even though a field value might pass a range check, the contents of another field might determine what a reasonable value for the field is.
  • Valid-Sign-Numeric: The content of one field might determine which sign is valid for a numeric field.
  • Size: If Variable-length records are used, the size of the record is a function of the sizes of the variable length fields or the sizes of fields that optionally might be omitted from the record. The permissible size of the fixed and variable – length records also might depend on a field indicating the record type.

• File checks: In file checks, validation control examines whether the characteristics of a file used during data entry are matching with the stated characteristics of the file. For example if auditors validate some of the characteristic of data that is keyed into an application system against a master file, they can check whether they are using the latest version of the master file.

• Processing controls: When input has been accepted by the computer, it usually is processed through multiple steps. Processing controls are essential to ensure the integrity of data. Almost all of the controls mentioned under input may also be incorporated during processing stage.

Processing validation checks primarily ensure that computation performed on numeric fields are authorised, accurate, and complete. The following validation checks may be indicated in this regard.

• Overflow: Overflow can occur if a field used for computation is not initiated to zero at start. Some error in computation occurs, or unexpected high values occur.
• Range: An allowable value range can apply to a field.
• Sign test: The contents of one record type field might determine which sign is valid for a numeric field.
• Cross-footing: Separate control totals can be developed for related fields and cross footed at the end of a run.
• Run-to-run control: In a tape based system, the processing of transaction file may involve several runs, for instance, a tape based order processing system might have a transaction tape that is used to update first a stock master file, then a sales ledger followed by a general ledger, various control totals may be passed from one run to the next as a check on completeness of processing.
• Recording control: Recording controls enable records to be kept free of errors and transactions details that are input into the system.
• Error log: This is particularly important in batch entry and batch processing system. Many of the accuracy checks can only be carried to during run time processing. It is important that a detected error does not bring the run to a halt, on discovery, the erroneous transaction is written to a error log file, which is examined at the end of processing. The errors can then be corrected or investigated with the relevant department before being input and processed.

• Transaction log: The transaction log provides a record of all transactions entered into the system as well as storing transaction details such as the transaction reference number, the date, the account number, the type of transaction the amount and the debit and credit references. The transaction will be “Stamped” with details of input. These typically include input time, input date, input day, terminal number and user number. It is used for multi-access main frame systems accounting transactions. The transaction log can form the basis of an audit trail and may be printed out for investigation during an audit.

• Storage control: These controls ensure the accurate and continuing and reliable storage of data. Data is a vital resource for an organisation and is the heart of CIS activities. Special care must be taken to ensure the integrity of the database or file system. The controls are particularly accidental erasure of files and the precision of back-up and recovery facilities. The following checks may be considered:
  • Physical protection against erasure: Magnetic tape files have rings that may be inserted if the files are to be written or erased. Read only files have the ring removed.
  • The controls in respect of floppy disks have a plastic lever, which is switched for read only purposes.
  • External label: These are attached to tape reels or disk packs to identify the contents.
  • Magnetic labels: This consists of magnetic machine readable information encoded on the storage medium identifying its contents. File header labels appear at the start of a file and identify the file by name, give the date of last update and other information. This is checked by software prior to file up dating. Trailer labels at the end of files often contain controls that are checked against those calculated during file processing.
  • File back-up routines: Copies are held of important files for security purposes. As the process of providing back-up often involves a computer operation in which one file is used to produce another, a fault in this process would have disastrous results; if both the master and the back-up were lost.
  • Database back-up routines: The contents of a data base held on a direct access storage device (DASD) such as magnetic disk are periodically dumped on to a back-up file. The back-up is usually a tape which is then stored together with the transaction log tape of all transactions occurring between the last and the current dump. If a fault in database, such as disk crash, happens afterwards the state of the data base can be recreated using the dumped data base tape, the stored transaction and the current log of transactions occurring between the dump and the crash point.
  • Cryptographic storage: Data is commonly written to files in a way that uses standard coding like ASCII or EBCDIC. It can be interpreted easily by unauthorised reader gaining access to the file. If the data is confidential or sensitive then it may be scrambled prior to storage and described on reading.

The security process involves the conversion of the plain text message or data into cipher text by the use of an encryption algorithm and an encryption key. The opposite process uses a description key to reproduce the plain text or message. If the encryption and decryption key are identical the entire procedure is called Symmetric Cryptograph, otherwise, it is known as asymmetric cryptograph.

• Output control: Output control ensures that the results of data processing are accurate, complete and are directed to authorise recipient. The auditor should examine whether audit trail relating to output was provided and the date and time when the output was so provided. This would enable the auditor to identify the consequences of any errors discovered in the output.
5.14 Computer Assisted Audit Techniques (CAATS)

The overall objectives and scope of an audit do not change when an audit is conducted in a Computer Information Systems (CIS) environment. The application of auditing procedures may, however, require the auditor to consider techniques known as Computer Assisted Audit. Techniques (CAATs) that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. CAATs are computer programs and data that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity’s information systems.

Uses of CAATs
CAATs may be used in performing various auditing procedures, including the following:

- Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records.
- Analytical procedures, for example, identifying inconsistencies or significant fluctuations.
- Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management.
- Sampling programs to extract data for audit testing.
- Tests of application controls, for example, testing the functioning of a programmed control.
- Re-performing calculations performed by the entity’s accounting systems.

Audit software
CAATs allow the auditor to give access to data without dependence on the client, test the reliability of client software, and perform audit tests more efficiently. CAATs may consist of package programs, purpose-written programs, utility programs or system management program. A brief description of the programs commonly used is given below:

- Package programs are generalised computer programs designed to perform data processing functions, such as reading data, selecting and analysing information, performing calculations, creating data files and reporting in a format specified by the auditor.
- Purpose-written programs perform audit tasks in specific circumstances. These programs may be developed by the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity’s existing programs in their original or modified state because it may be more efficient than developing independent programs.
- Utility programs are used by an entity to perform common data processing functions, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic record counts or control totals.
- System management programs are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

Considerations in the use of CAATs
When planning an audit, the auditor may consider an appropriate combination of manual and computer assisted audit techniques in determining whether to use CAATs, the factors to consider include:

- the IT knowledge, expertise and experience of the audit team
- the availability of CAATs and suitable computer facilities and data
- the impracticability of manual tests
- effectiveness and efficiency
- time constraints
Before using CAATs the auditor considers the controls incorporated in the design of the entity’s computer systems to which CAAT would be applied in order to determine whether, and if so, how, CAATs should be used.

Auditing in computer information systems environment deals with the level of skill and competence the audit team needs to conduct an audit in a CIS environment. It provides guidance when an auditor delegates work to assistants with CIS skills or when the auditor uses work performed by other auditors or experts with such skills. Specifically, the audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted. The level of knowledge required depends on “availability of CAATs” and “suitable computer facilities”.

Availability of CAATs and suitable computer facilities
The auditor considers the availability of CAATs, suitable computer facilities and the necessary computer-based information systems and data. The auditor may plan to use other computer facilities when the use of CAATs on an entity’s computer is uneconomical or impractical, for example, because of an incompatibility between the auditor’s package program and entity’s computer. Additionally, the auditor may elect to use their own facilities, such as PC’s or laptops. The cooperation of the entity’s personnel may be required to provide processing facilities at a convenient time, to assist with activities such as loading and running of CAAT on the entity’s system, and to provide copies of data files in the format required by the auditor.

• Impracticability of Manual Tests: Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. In addition, many computer information systems perform tasks for which no hard copy evidence is available and, therefore, it may be impracticable for the auditor to perform tests manually. The lack of hard copy evidence may occur at different stages in the business cycle.

• Effectiveness and Efficiency: The effectiveness and efficiency of auditing procedures may be improved by using CAATs to obtain and evaluate audit evidence. CAATs are often an efficient means of testing a large number of transactions or controls over large populations by:
  - analysing and selecting samples from a large volume of transactions
  - applying analytical procedures
  - performing substantive procedures

• Matters relating to efficiency that an auditor might consider include:
  - the time taken to plan, design, execute and evaluate CAAT
  - technical review and assistance hours
  - designing and printing of forms (for example, confirmations)
  - availability of computer resources

In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application. The initial planning, design and development of CAAT will usually benefit audits in subsequent periods. Time Constraints certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data. Where the time available to perform an audit is limited, the auditor may plan to use CAAT because its use will meet the auditor’s time requirement better than other possible procedures.

• Using CAATs: The major steps to be undertaken by the auditor in the application of CAAT are to:
  - set the objective of CAAT application
  - determine the content and accessibility of the entity’s files
  - identify the specific files or databases to be examined
  - understand the relationship between the data tables where a database is to be examined
  - define the specific tests or procedures and related transactions and balances affected
  - define the output requirements
  - arrange with the user and IT departments, if appropriate, for copies of the relevant files
or database tables to be made at the appropriate cutoff date and time;
- identify the personnel who may participate in the design and application of CAAT
- refine the estimates of costs and benefits
- ensure that the use of CAAT is properly controlled
- arrange the administrative activities, including the necessary skills and computer facilities
- reconcile data to be used for CAAT with the accounting and other records
- execute CAAT application
- evaluate the results
- document CAATs to be used including objectives, high level flowcharts and run instructions
- assess the effect of changes to the programs/system on the use of CAAT

- Testing CAAT: The auditor should obtain reasonable assurance of the integrity, reliability, usefulness, and security of CAAT through appropriate planning, design, testing, processing and review of documentation. This should be done before reliance is placed upon CAAT. The nature, timing and extent of testing is dependent on the commercial availability and stability of CAAT.

- Controlling CAAT Application: The specific procedures necessary to control the use of CAAT depend on the particular application. In establishing control, the auditor considers the need to:
  - approve specifications and conduct a review of the work to be performed by CAAT
  - review the entity’s general controls that may contribute to the integrity of CAAT
  - ensure appropriate integration of the output by the auditor into the audit process. Procedures carried out by the auditor to control CAAT applications may include:
    - participating in the design and testing of CAAT
    - checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications
    - asking the entity’s staff to review the operating system instructions to ensure that the software will run in the entity’s computer installation
    - running the audit software on small test files before running it on the main data files
    - checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete
    - obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information
    - establishing appropriate security measures to safeguard the integrity and confidentiality of the data

When the auditor intends to perform audit procedures concurrently with online processing, the auditor reviews those procedures with appropriate client personnel and obtains approval before conducting the tests to help avoid the inadvertent corruption of client records.

To ensure appropriate control procedures, the presence of the auditor is not necessarily required at the computer facility during the running of CAAT. It may, however, provide practical advantages, such as being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.
Summary

- Computerisation has a significant effect on organisation control, flow of document information processing and so on.
- The effect of changes on accounting process fall under two types of changes. Primary changes and recent changes.
- Auditors must be alert to the growth and development in the field of information technology because this field is very a fast growing technology.
- The Auditor concentrates on input and output and ignores the specifics of how computer process the data or transactions in the Black box approach or Auditing around the computer.
- Auditing around the computer has the advantage of ease of comprehension as the tracing of documents to output does not require any in-depth study of application program.
- The processes and controls surrounding the subject are subject to audit as well as the processing controls operating over auditing through the computer process are investigated.
- The process of auditing is not a straight forward flow of work from start to finish to be completed by satisfying oneself against a standard checklist or a list of questions.
- The various types of controls for its efficient and effective functioning get affected by the nature and type of system.
- The processing task of multiple users is performed on a single centralised computer, in large system computers.
- A network is a group of interconnected system sharing services and interacting by a shared communication links.
- Internal control system include separation of duties, delegation of authority and responsibility, a system of authorisation, adequate documents and records, physical control over assets and records, management supervision, independent checks on performance and periodic reconciliation of assets with records.
- The objective of auditing, do not undergo a sea change in a CIS environment.
- Internal control is an essential prerequisite for efficient and effective management of any organisation.
- In evaluating the effects of a control, the auditor needs to assess the reliability by considering the various attributes of a control.
- General controls in a CIS environment falls under the three basic control approaches as seen under manual system, i.e. Feedback, feed-forward and preventive control.
- The overall objectives and scope of an audit do not change when an audit is conducted in a Computer Information Systems (CIS) environment.

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Recommended Reading

Self Assessment

1. Auditing in a CIS environment even though has not changed the fundamental nature of auditing; it has definitely caused substantial changes in the method of evidence ____________ and evaluation.
   a. selection
   b. collection
   c. gathering
   d. evaluate

2. How many types of changes fall under the effect of changes on accounting process?
   a. Two
   b. Three
   c. Five
   d. Six

3. Match the following

<table>
<thead>
<tr>
<th>1. Large system computers</th>
<th>A. Two or more computers located within a small distinct area like room, office or campuses are connected through cables.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Stand alone personal computers</td>
<td>B. Is a group of interconnected system sharing services and interacting by a shared communication links.</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>3. Network computing system</td>
<td>C. The processing task of multiple users is performed on a single centralised computer.</td>
</tr>
<tr>
<td>----------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>4. Local area network</td>
<td>D. Is one that is not connected to or does not communicate with another computer system.</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>

   a. 1-D, 2-B, 3-A, 4-C
   b. 1-B, 2-A, 3-C, 4-D
   c. 1-C, 2-D, 3-B, 4-A
   d. 1-A, 2-C, 3-D, 4-B

4. Which of the following statement is false?
   a. When accounting processes are computerised under CIS environment, the process of recording transaction undergoes a major change.
   b. Mechanisation often results in the abandonment in whole or sometimes it can be in part of the primary records.
   c. Bound hand written records as used in manual accounting processes are replaced by loose-leaf machine written records in electronic medium.
   d. In computerised information systems, alpha-numeric codes are briefly used to represent names and description

5. Under __________ processing mode, a continuous dialogue exists between the user and the computer.
   a. batch
   b. interactive
   c. one line
   d. time
6. __________control is an essential prerequisite for efficient and effective management of any organisation.
   a. Internal
   b. Audit
   c. External
   d. CIS

7. Which of the following statement is true?
   a. In a manual system, different persons are responsible for carrying out function like initiating, recording of transaction, safeguarding of assets, always apply in a computer system.
   b. A structured authority and responsibility is an unnecessary control within manual and computer environment.
   c. Skilled, competent, well-trained and experienced information system personnel have been in short supply.
   d. In a manual system, insufficient documents and records are required to provide an audit trail of activities within the system.

8. __________ controls ensure the accurate and continuing and reliable storage of data. Data is a vital resource for an organisation and is the heart of CIS activities.
   a. Recording
   b. Storage
   c. Processing
   d. Input

9. The Auditor concentrates on input and output and ignores the specifics of how computer process the data or transactions in the __________ box approach or Auditing around the computer.
   a. Black
   b. White
   c. Blue
   d. Grey

10. __________ controls in a CIS environment falls under the three basic control approaches as seen under manual system, i.e. Feedback, feed-forward and preventive control.
    a. Input
    b. General
    c. Processing
    d. Storage
Chapter VI
Audit of Limited Companies

Aim
The aim of this chapter is to:

• introduce the company auditor
• highlight the qualifications and disqualifications of company auditor
• describe appointment of an auditor

Objectives
The objectives of this chapter are to:

• elucidate the process of reappointment of auditors
• explain the procedure of removal of auditor
• explicate special audit of banking companies

Learning outcome
At the end of this chapter, you will be able to:

• understand the rights and duties of a company auditor
• comprehend the audit of educational institutions
• discuss the audit report
6.1 Introduction

Audit plays a pivotal role in keeping proper legal check on those who carry on the business in a fiduciary capacity. Shareholders not being legal experts, the auditor acts as a link between the shareholders and the management. Statutory auditing, mandatory for all companies, is one of the regulatory mechanism designed to check abuses and irregularities in the financial aspects of the companies. There are numerous provisions incorporated in the Companies Act, 1956 stipulating the norms and rules to be followed in maintaining the accounts of the company.

All companies are statutorily required to prepare and maintain accounts which are then scrutinised by the auditor who certify their correctness. For company accounts to be credible they must be true and fair and this is more likely to happen if someone competent and independent of the company has vetted the accounts. An auditor has a fiduciary relationship with the company. The statutory auditors are often described as the watchdogs of the company. They have access to the book of accounts, vouchers and documents, which no member of the company has. At the same time a number of duties and responsibilities are cast upon them.

6.2 Need for a Company Auditor

The main purpose of appointing an auditor or auditors in a company is to safeguard the interests of the shareholders because, for every shareholder, it is neither possible to inspect the books of account of the company personally nor to participate in its management actively. An auditor, therefore, is a representative of the shareholders and he works on their behalf. He is to ensure that the directors have maintained proper books of account, the accounting records are correct and genuine, the company has complied with the provisions of the Companies Act, and that nothing has been done to jeopardise the interests of the shareholders deliberately.

When the auditor reports to the shareholders expressing satisfaction, his opinion serves as an assurance that everything relating to accounts is in order in the company. He is primarily to protect the rights of the shareholders. Those who are responsible for the management of its affairs must not work against the interests of the shareholders either in using the assets of the company or in distributing the dividend. An auditor, therefore, has to exercise reasonable amount of care and skill in his job because the shareholders rely primarily upon his opinion in this regard. If there is any irregularity in the books of account, or something is being done in the company which is illegal and improper, this will adversely affect the interests of the shareholders. Hence, the auditor should report all such cases of irregularity to the shareholders. The main responsibility of an auditor is to examine the books of account of the company as maintained by its officers and to report to the shareholders that the financial position of the company as represented by its balance sheet gives a true and fair view of its state of affairs.

6.3 Qualification of a Company Auditor

According to Section 226(1) and (2) of the Companies Act, 1956, the prescribed qualifications of a company auditor are as follows:

- A person shall not be qualified for appointment as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountant’s Act, 1949. Provided that a firm whereof all the partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company, in which case any partner so practising may act in the name of the firm.

- A person who holds a certificate under the Restricted Auditor’s Certificate Rules, 1956, is also qualified to act as an auditor of company. Such persons are called certified auditors and are always subject to the rules made in his behalf by the Central Government.

6.4 Disqualification of a Company Auditor

Section 226(3) of the Act further provides that the following are not qualified for appointment as a company auditor:

- A body corporate

- An officer or employee of the company:
  - a person who is a partner, or who is in the employment, of an officer or employee of the company.
  - a person who is indebted to the company for an amount exceeding Rs. 1000, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding, Rs. 1000.
Moreover, if a person is appointed as company auditor and subsequently becomes disqualified, he is deemed to have automatically vacated his office as auditor of the company form the date of his disqualification.

Rationale for restrictions
You have noted here that some statutory restrictions have been imposed on the appointment of an auditor in a company in respect of his qualifications. The reasons for such restrictions are as follows:

- The process of auditing involves an independent examination of accounts to ensure that they are free from errors or frauds. This is a professional responsibility expecting expertise as well as integrity.
- An efficient performance of duties by a company auditor is an equally important aspect of law. He is, therefore, under the discipline or a recognised professional accountancy body, is, Institute of Chartered Accountants of India.
- A company auditor needs legal protection as well as the support of an organised professional body in discharging his duties in an independent manner.
- Unbiased attitude and impartial judgement are necessary for a company auditor both in verification of accounts and in expression of his opinion on the financial statements of the company.
- Undue connection or association of a company auditor with the directors or officers of the company either as a partner or as an employee defeats the very purpose of auditing and the concept of independence.

6.5 Appointment of an Auditor

Section 224 of the Companies Act provides “Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed”.

If you translate this provision into rules of appointment of a company auditor, these will be as follows:

- A company auditor is normally appointed at the annual general meeting of the company.
- The tenure of appointment of a company auditor is from one annual general meeting to another.
- That when an auditor is appointed in a company, he should be intimated about it within seven days of such appointment.

Besides these three basic rules for the appointment of a company auditor, the supplementary considerations are:

- that a written certificate and consent should be obtained from the proposed auditor before his appointment is finalised by the company.
- that in case a company is unable to appoint an auditor at its annual general meeting, the central government has the powers to make such an appointment to fill the vacancy.
- that no one is appointed as a company auditor who holds such appointment in twenty companies at a time and
- that the appointed auditor should communicate to the Registrar of Companies, within thirty days of the receipt of intimation from the company, whether he accepts or refuses to accept the appointment.

6.5.1 First Auditor of a Company

A company may be registered any time during the year and, therefore, its date of registration may differ from the date of commencement of its normal accounting year. Hence, the company shall also need an auditor for that partial period of its operation which proceeds the normal accounting year. The auditor to be appointed for this initial and partial period of the company is known as the first auditor. Such appointments are made by taking into consideration the following factors:

- The first auditor or auditors of any company are appointed by the Board of Directors of the company.
- Such appointment is to be made within one month of the date of registration of the company.
- The first auditor will hold office until the conclusion of the first annual general meeting of the company.
6.5.2 Reappointment of Auditors

A statutory auditor is not appointed on a permanent basis. It is normally an annual assignment. It may, however, be renewed and extended for another term. When the previous auditor of the company is allowed to continue for the next year, it is considered as a reappointment. Under normal circumstances, a retiring auditor is reappointed as a company auditor. In some cases, however, this may not be so owing to the following reasons:

- The auditor is now not qualified for reappointment.
- The auditor has expressed his unwillingness to be reappointed by giving the company a notice in writing about his intention to discontinue.
- The company has passed a resolution at the general meeting to appoint somebody else as the company auditor, or not to reappoint the retiring auditor or
- Notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor and by reason of the death, incapacity or disqualification of that person or of all those persons, the resolution cannot be proceeded with.

6.6 Removal of an Auditor

An Auditor of a company can be removed from office before the expiry of his term in the following manners:

- When the company takes such decision at its general meeting
- By an ordinary resolution of which special notice has been given and
- After obtaining the previous approval of the central government.

The first auditors of a company appointed by its Board of Directors can be removed at a general meeting by an ordinary resolution of which a special notice is given. Thus, you see that in all matters relating to appointment, reappointment, removal or retirement of an auditor, the shareholders of the company play an important role. This once again establishes the fact that the auditor is responsible to the shareholders. He acts on their behalf, and not on behalf of the directors. He is shareholders’ representative and his statutory duties are to safeguard their interest.

There is one more process of protection given to auditors against their undue removal. If an auditor other than the retiring auditor is to be appointed, special notice must be given to the company by a member before the annual general meeting. A copy of this notice must be sent to the retiring auditor as well as to all members prior to the general meeting. The retiring auditor, after getting a copy of the notice, may make a written representation to the company and ask the company to circulate it among the members of the company. Besides, the retiring auditor has the power to attend the annual general meeting at which the proposal for his removal is being considered and to address the members.

6.7 Status of an Auditor

Now the question arises as to what is the real status of an auditor in a company. Obviously, an auditor enjoys a legal status. In other words, a company auditor is a statutory auditor, because he is appointed strictly in accordance with the provisions of the law. The status of an auditor in a company is governed by the following principles:

- An agent: The auditor is an agent of the members of the company appointed to perform duties as laid down by (a) the Companies Act, (b) the Articles of Association of the company, and (c) the audit agreement between the auditor and the client.
- Not an advisor: An auditor is not an advisor to the company. It is not a part of his duty to advise the directors or shareholders.
- Not a detective: An auditor is neither a detective nor an employee of the company. He is a watchdog and not a bloodhound. He need not be unduly suspicious in his job.
- Not to discover Frauds: it is not the responsibility of the auditor to discover frauds which have been carefully perpetrated. He can rely upon the honesty of the employees of the company who enjoy a position of confidence in the organisation.
- Not a guarantee: An auditor’s opinion on the financial statements of the company does not mean an automatic guarantee of correctness of books of account.
- An officer: Although an auditor is not an employee of a company, he is treated as an officer of the company under various provisions of the Companies Act.
6.8 Rights and Duties of a Company Auditor

Following are the rights and duties of a company auditor.

6.8.1 Rights

The Act provides for the following rights to the auditors of a company:

- **Rights of access to books of accounts:** Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the head office or elsewhere. The books include not only the financial books of the company but also the statutory and statistical books.

- **Rights to obtain information and explanation:** The auditor is entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor.

- **Right to receive notices and attend general meetings:** According to Section 231 of the Act, the auditor has a right (a) to receive all notices and other communications relating to any general meeting of the company; (b) to attend any general meeting of the company; and (c) to be heard on any part of the business which concerns him as an auditor at any general meeting.

- **Right to make corrections in the financial statements:** The auditor is requested to conduct an independent examination of the books of account of a company and report to the shareholders whether the financial statements show a true and fair view of the state of affairs of the company. Hence, if he finds some fault, he has the right to make the necessary corrections. If his suggestions are not carried out, he has the right to refer the matter in his report.

- **Right to visit branches:** Where the branch accounts are not audited by a qualified auditor, the company auditor has a right of access at all times to the books of accounts and vouchers of the company as maintained at the branch office and my visit the branch of deems it necessary.

6.8.2 Duties

The duties of a company auditor can be divided into three categories such as:

**Duties relating to audit report**

The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss account and on every other document declared by this Act to be part of or annexed to the balance sheet or profit and loss account, which are laid before the company in general meeting during his tenure of office. The report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Act in the manner so required and give a true and fair view.

- in the case of the Balance Sheet, of the state of the company’s affairs as at the end of its financial years; and
- in the case of the Profit and Loss Account, of the profit or loss for its financial year.

The auditor’s report shall also state that:

- whether he has obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit;

- whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns adequate for the purposes of his audit has been received from branches not visited by him; and

- whether the company’s Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

**Duties relating to enquiry**

The auditor should specifically enquire into the following six matters:

- Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company.

- Whether the transactions which are not supported by any facts or evidence, though recorded in the books, are not prejudicial to the interests of the company.
Where the company is not an investment company or a banking company, whether it has sold any shares, debentures or other securities at a price which is lower than the price at which they were purchased by the company,

Whether loans and advances made by the company have been shown as deposits.

Whether any personal expenses have been charged to revenue accounts of the company.

Where the books of the company show that shares have been issued for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been received, whether the position as stated in the books and the Balance Sheet is correct, regular and not misleading.

Other statutory duties
The following are the other statutory duties:

- The prospectus issued by an existing company should contain an auditors report regarding (a) profit and losses, (b) assets and liabilities, (c) rate of dividends paid for each of the five financial years preceding the issue of the prospectus. Hence it is the duty of auditor to submit such report.

- The auditor has to certify a statutory report.

- The auditor has to sign his report.

- Where an inspector is appointed by the Central Government to investigate the affairs of the company, it is the duty of the auditor to give him all assistance in the investigation.

- When a company goes into voluntary winding up and a declaration of solvency is made by the directors, the auditor shall submit his report on the Profit and Loss Account and the Balance Sheet.

It is important to note here that the rights and powers of auditors cannot be limited or abridged either by the Articles of Association or by the directors or shareholders of the company.

6.8.3 Some Legal Decisions
The following legal decisions further highlight the role or the auditors in discharging their statutory responsibilities:

- It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the Balance Shed, but to see that it is a true and accurate representation of the company’s affairs. (Leeds Estate Building and Investment Co. vs. Shepherd, 1887)

- An auditor must be honest, that is, he must not certify what he does not believe to be true and he must take reasonable care and skill before he believe that what he certifies is true. (London and General Bank, 1895).

- It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case (Kingston Cotton Mills Co. Ltd., 1896).

- The auditor undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties or by want of reasonable care he neglects his duty, and damage is caused to the company as such, he is responsible for that damage (London Oil Storage Co. Ltd. vs. Seear, Hasluck and Co., 1904).

- When the reports of the auditors are not communicated to the shareholders, directors are responsible for this lapse. Auditor’s duties are discharged when their reports are delivered to the company. It is the duty of the directors to summon the shareholders’ meeting and to see that the report of the auditors is read at the meeting. (Allen. Craig & Co. Ltd. 1934).

- The vital task of the auditor is to ensure that errors are not made. He must carry out this task with an enquiring mind and not with suspicion of honesty. He should proceed with his work suspecting that someone might have made a mistake somewhere and that a check must be made to ensure that there has been none. (Fomento Ltd, vs. Selsdon Fountain Pen Co. Ltd., 1958).
6.9 Auditing Standards

It may be of interest to you that international standards also guide the role of auditors. Their approach to company audit is now based on the following professional guidelines:

- An audit is the independent examination of, and expression of opinion on, the financial statements of a company by an appointed auditor in pursuance of that appointment and in compliance with relevant statutory obligation.
- The responsibility for the preparation of the financial statements and the presentation of the information included therein rests with the directors of the company. The auditor’s responsibility is to report on the financial statements as presented by the management.
- The auditor should adequately plan, control and record his work.
- The auditor should ascertain the company’s system of recording and processing transactions and assess its adequacy as a basis for the preparation of financial statements.
- The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom.
- If the auditor wishes to place reliance on any internal controls, he should ascertain and evaluate those controls and perform compliance tests on their operation.
- The auditor should carry out such a review of the financial statements as is sufficient, in conjunction with the conclusions drawn from the other audit evidence obtained, to give him a reasonable basis for his opinion on the financial statements.

The normal expectation from the auditor, therefore, is to express an independent judgement on the results and financial position of the company, free from any pressure which the management or owners of that company might seek to exert.

6.10 Divisible Profits and Dividend

Dividend means divide the profit of the company, at the end of year, among shareholder of the company.

Types of dividend

The types of dividend are as follows:

- Proposed dividend: Dividend recommended by the Board is called as proposed dividend. The Board specifies in its report, the amount it recommends for payment of dividend (Sec. 217), which is attached to the balance sheet for the relevant financial year.
- Final dividend: Proposed dividend, when consented to by the shareholders at the annual general meeting becomes final dividend. Thus, dividend is declared by the members in the annual general meeting. It is the discretion of the board of director to recommend or not to recommend the declaration of final dividend, which has to be exercised in good faith in the interest of the company. The shareholders have no power to declare final dividend in the absence of a recommendation of the board of directors.
- Interim dividend: The dividend declared y the Board for a financial year during such financial year is called interim dividend. Thus, it is declared in between two AGM. No specific power in the articles is required for declaration of interim dividend.
Declaration of dividend
Following are the ways of declaration of dividend.

• Declaration of dividend out of profits
  • Calculation of Divisible Profit

<table>
<thead>
<tr>
<th>Calculation of Divisible Profit</th>
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</thead>
<tbody>
<tr>
<td>Profits</td>
</tr>
<tr>
<td>a) (Less): Current year depreciation (if not provided)</td>
</tr>
<tr>
<td>b) (Less): Loss of PY OR Depreciation of PY - whichever is less</td>
</tr>
<tr>
<td>c) (Less): Amount to be transferred to reserves</td>
</tr>
<tr>
<td>Divisible profits (Such amount can be declared as dividend)</td>
</tr>
</tbody>
</table>

• Distributable Profit – transfer of profit to reserve

<table>
<thead>
<tr>
<th>% of Dividend of paid-up capital</th>
<th>% of C.Y. profit to be transferred to reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Upto 10%</td>
<td>Nil</td>
</tr>
<tr>
<td>More than 10% &amp; upto 12.5%</td>
<td>Minimum 2.5 %</td>
</tr>
<tr>
<td>More than 12.5% &amp; upto 15%</td>
<td>Minimum 5 %</td>
</tr>
<tr>
<td>More than 15% &amp; upto 20%</td>
<td>Minimum 7.5 %</td>
</tr>
<tr>
<td>Above 20%</td>
<td>Maximum 10</td>
</tr>
</tbody>
</table>

Note – If company wants to transfer more than 10% of its net profit to reserves, then the company must satisfy following two Conditions, which are as follows.

Condition 1 – Dividend is Declared in Current Year
Satisfy following two conditions –
• Current year dividend ≥≥ Avg. Dividend rate of last 3 financial years
• If Bonus share is declared in any of last 3 years, then

Dividend amount is current financial year ≥≥ avg. dividend amount of last 3 financial years

Provided (i.e., No need to fulfil above 2 condition, if)
Net profit of current year of company falls below 20% or more that of Average net profit of last 2 years

Condition 2 – Dividend is Not Declared in C.Y. & co’ wants to transfer its profit to reserve
• Amount transferred to reserve << Avg. dividend amount of last 3 financial years

Declaration of dividend out of reserve
• Interim dividend should not be declared out of reserves
• In a year in which the profits of the company is inadequate or there is no profit, the company may declare and pay dividend out of free reserve

Conditions to be satisfied, if company pay dividend out of reserves
• Regarding rate of dividend
  Dividend rate must be lower of :
  • Average dividend rate of last 5 years; or 10%
  • Amount drawn from reserves shall not exceed 10% of sum of paid up capital + reserves.
  • The amount so withdrawn should be first utilised to setoff current year losses.
  • Balance of reserves after such withdrawal should not fall below 15% of paid-up capital.
6.11 Audit Report

Audit Report is the report given by the Auditor after checking the accuracy of the data. The Audit report contains the findings identified by the Auditor in the data checked by him and gives his opinion on the quality of the data. There are many types of Audits like Tax audit, Cost Audit, Company’s statutory audit, Bank Audit.

Need and importance of audit report

Reporting is essential to the audit process because it explains what the auditor did and the conclusions reached. The need of auditor’s report is governed by the following provisions of the Companies Act, 1956.

- That at every annual general meeting of a company, the Board of Directors of the company shall lay before the company:
  - a balance sheet as at the end of the period; and
  - a profit and loss account for the period [Sec. 210].
- That every balance sheet of a company shall give a true and fair view of the state of affairs of a company as at the end of the financial year. Similarly, every profit and loss account shall give a true and fair view of the profit and loss of the company for the financial year [Sec. 211].
- That the profit and loss account shall be annexed to the balance sheet and the auditor’s report including the auditor’s separate, special or supplementary report shall be attached thereto [Sec. 215].

The auditor of a joint stock company is appointed and entrusted to check the correctness and fairness of the financial statements. An auditor occupies a fiduciary position, i.e., a position of trust and confidence in a company. The shareholders, who are in dark about the state of affairs of the company’s business, extend their trust, faith and confidence to the report submitted by the auditors. Audit report enables the auditors to explain to the entire body of shareholders what they consider relevant and significant information relating to the financial state of company’s affairs for the period under audit. It thus, serves the under mentioned purposes.

- It substantiates that the financial information of the company reflects a true and fair picture of the state of affairs of company’s business.
- It summarises the results of the audit work carried out by the auditor.
- Apart form acquainting the shareholders with material facts about the affairs of company’s business, it offers an opportunity to the readers of financial statements, viz., creditors, bankers, financial institutions and potential investors to get reliable insight into the financial position of the company as reflected by its profit and loss account and the balance sheet.
- Auditor’s report is the indicator of creditability of financial statements.

Thus, an auditor’s report is a valuable document in which the auditor sets forth the scope and nature of the audit and also gives his impartial opinion as regards the financial state of company’s business. The auditor makes a report to the members on the financial statement examined by him and therefore, acquaints them with the true and fair state of the company’s affairs. Frequently, it is the only part of the audit, users of financial statements see. Therefore, from the user’s point of view, the report is the product of an audit. However, the audit report does not guarantee that every detail of the company’s books of account is correct. It should be noted that an auditor is not a guarantor or an insurer. Even if he gives a clean report, it does not amount to complete accuracy of the accounts. His main duty is to report to the members whether the balance sheet and profit and loss account exhibit true and fair position of company’s affairs or not.

6.11.1 Responsibilities of an Auditor for Making a Report

To make a report on the accounts examined by him to the members of the company is one of the statutory duties of an auditor. The main duties and responsibilities of a company auditor with regard to the report are:

- To safeguard the interest of the shareholders against any misuse of powers by the company directors in managing the assets of the company.
- To examine the books of account adequately in order to judge the genuineness and validity of the transactions with ultimate object to acquaint the shareholders with the true financial position of the company.
• To highlight in the report any such activity of the management which in his opinion may endanger the interest of the investors, viz., shareholders and or creditors who have contributed to its capital.

• To bring to the notice of the directors and shareholders the fact whether the accounts have been prepared and presented in accordance with the accepted principles of accountancy.

• To see that the report reaches the members of the company by attending the annual general meeting. It must, however, be noted that the ultimate responsibility to circulate the auditor’s report among the members or shareholders lies with the directors of the company.

6.11.2 Requisites of a Good Audit Report

The auditor’s report should conform to the following criteria:

• Based on factual information: The audit report should contain only factual information about the state of affairs of the company. The auditor should base his opinion on the information ascertained by him and explanation given by the management, failing which the audit will not serve its purpose.

• Effective presentation: The presentation of the auditor’s report should be forceful and in a manner prescribed by the Companies Act. An auditor should make it sure that the report is made available to the shareholders by attending the general meeting.

• Honest disclosure of discrepancies in the internal control: The audit report should contain an honest expression of opinion. If the report does not highlight discrepancies or weaknesses in the internal control system, then the shareholders and the management will remain in dark as to the actual state of company’s affairs. Thus, auditor should highlight the weak areas of performance in the report.

• Impartial approach: The auditor should adopt independent and unbiased approach while writing and presenting the report. An auditor of a company is appointed by shareholders, and his duty is to investigate the work of directors and ascertain all the information and explanations necessary for the purpose of his audit, and make a report on the basis of his findings. If audit report does not reflect an independent and unbiased opinion of the auditor, there will be no sanctity of such audit. The report should reflect an impartial attitude of the auditor.

• Balanced criticism and logical suggestions: The auditor should present a report on the state of affairs of the company after critical evaluation of the accounting system and policies of the company. The report should contain a balanced criticism of policies, procedures, accounting and internal control system followed by the company.

• Clear and unambiguous language: The audit report is the most important form of communication used by the auditor. It must clearly and concisely communicate the nature of the auditor’s examination. Therefore, report should be written in an unambiguous language. Language of the audit report should be such that its readers could understand its subject matter clearly.

• Precise, brief and complete: The audit report should be brief and to the point. It should contain the relevant and material particulars only. Any immaterial and irrelevant information in the report will contribute to nothing but creating confusion for the readers of the report. The report should be complete in all respects. The auditor should not skip any material fact while drafting his report on the financial information examined by him. The auditor should not confine his audit report to the shareholders and management alone; it should also cater to the interest of the potential investors.

6.11.3 Types of Audit Report

An audit report is an appraisal of a small business’s complete financial status. Completed by an independent accounting professional, this document covers a company’s assets and liabilities, and presents the auditor’s educated assessment of the firm’s financial position and future. Audit reports are required by law if a company is publicly traded or in an industry regulated by the Securities and Exchange Commission (SEC). Companies seeking funding, as well as those looking to improve internal controls, also find this information valuable. There are four types of audit reports.
Unqualified opinion
Often called a clean opinion, an unqualified opinion is an audit report that is issued when an auditor determines that each of the financial records provided by the small business is free of any misrepresentations. In addition, an unqualified opinion indicates that the financial records have been maintained in accordance with the standards known as Generally Accepted Accounting Principles (GAAP). This is the best type of report a business can receive. Typically, an unqualified report consists of a title that includes the word “independent.” This is done to illustrate that it was prepared by an unbiased third party. The title is followed by the main body. Made up of three paragraphs, the main body highlights the responsibilities of the auditor, the purpose of the audit and the auditor’s findings. The auditor signs and dates the document, including his address.

Qualified opinion
In situations when a company’s financial records have not been maintained in accordance with GAAP but no misrepresentations are identified, an auditor will issue a qualified opinion. The writing of a qualified opinion is extremely similar to that of an unqualified opinion. A qualified opinion, however, will include an additional paragraph that highlights the reason why the audit report is not unqualified.

Adverse opinion
The worst type of financial report that can be issued to a business is an adverse opinion. This indicates that the firm’s financial records do not conform to GAAP. In addition, the financial records provided by the business have been grossly misrepresented. Although this may occur by error, it is often an indication of fraud. When this type of report is issued, a company must correct its financial statement and have it re-audited, as investors, lenders and other requesting parties will generally not accept it.

Disclaimer of opinion
On some occasions, an auditor is unable to complete an accurate audit report. This may occur for a variety of reasons, such as an absence of appropriate financial records. When this happens, the auditor issues a disclaimer of opinion, stating that an opinion of the firm’s financial status could not be determined.

6.12 Special Audit of Banking Companies
The audit of the banks should be well-acquainted with the relevant provision of the special enactment that govern different types of banks, particularly those which affect the various items of the financial implications of the business carried on by banks and the types of the transaction that arise in the day-to-day operations.

6.12.1 Legislations Relevant to Audit of Banks
The provisions of many Acts relevant to audit of different types of banks are as follows.

• An auditor of the banks should acquaint with the specific provision of the Acts applicable to the type of banks under audit.

• Nationalised banks are governed by the provisions of the relevant Banking companies Act. Certain provision of the Banking Regulation act 1949 also applicable to nationalised banks

• The non-nationalised banking companies are governed by the provision of the Banking Regulation Act 1949.

• Co-operative banks are governed by the Co-operative Societies Act 1912 or the Co-operative Societies Act of the state in which they are situated, as well as by Part- v of the Banking Regulation act 1949.

• Certain provision of the Banking Regulation act have been modified while certain others have been omitted in their allocation to co-operative banks. Regional rural banks are governed by the Regional rural banks Act 1976.

• The provisions of the State bank of India Act 1955, and the State bank of India (subsidiary banks) Act 1959, apply State bank of India and its subsidiaries respectively. Certain specified provisions of the Banking Regulation act 1949, are applicable to regional rural banks as well as to the State bank of India and its subsidiaries.
6.12.2 Provision Relating to Audit

Appointment of an auditor

The auditor of a banking company, a nationalised bank or a regional rural bank has to be a person who is duly qualified under law to be an auditor of companies. Thus, the auditor of the companies under sec 226 of the companies Act 1956, and who does not attract any disqualification laid down therein. The auditor of a nationalised bank is appointed by the board of directors of the bank concerned, whereas the auditor of a banking company is appointed by the shareholder at the annual general meeting. Previous approval of RBI for appointment of the auditor is required in both cases. The auditors of the state bank of India are appointed by RBI in consultation of the Central government. The auditors of the subsidiaries of the state bank of India are appointed by the state bank of India. It may be mentioned in the State bank of India Act 1955, specially provides for the appointment of the ‘two or more auditors’. The auditors of the regional rural banks concerned with the approval of the Central Government. The appointment of auditor of a cooperative bank is governed by the relevant Cooperative bank is governed by the relevant Cooperative Societies Act.

Procedure for the appointment in case of nationalised banks

The statutory central auditors are appointed by the bank concerned on the basis of the names recommended by the RBI from out of panel of auditors. For this purpose, the RBI formulates detailed norms on the basis of which a panel is created by the Comptroller and Auditor General of India. Generally, each nationalised bank appoints 4-6 statutory central auditors. As per the norms prescribed by the RBI, to be eligible for empanelment, a firm should, as on January 1 of the relevant year, meet the minimum eligibility norms relating to;

- Number full time partners
- Numbers of FCA partners
- Number of years the firm has been existence
- Period of minimum continuous association of partners with the firm
- Number of full time charted accountants
- Number of professional staff
- Experience of statutory audit of public sector banks having deposits of at least the prescribed sum.
- Experience of statutory audit of public sector undertakings. At least one partner should have qualifications in computer audit.

6.12.3 Powers of the Auditor

The auditor of a bank has same powers as those of company auditor, except that the power the auditor of a co-operative is governed by the relevant Co-operative Societies Act.

6.12.4 Auditor’s Report

The contents of the auditor report in case of different types of banks are somewhat different.

Banking companies

In addition to the matters which he is required to state in his report under the companies Act, the auditor of banking company incorporated in India has also to state the following in his report to the shareholder:

- Whether or not the information and explanations required by him have been found to be satisfactory
- Whether or not the transactions of the company which have come to his notice have been within the powers of the company
- Whether or not the returns received from branch offices of the company have been found adequate for the purposes of his audit
- Whether the profit and loss account shows a true balance of profit or loss for the period covered by such account
- Any other matter which he considers should be brought to the notice of the shareholders of the company.
Nationalised banks
The auditor of the nationalised bank, State bank of India or its subsidiary is required to report to the central government and has to state the full in his report:

- Whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the affairs of the bank, and in the case he had called for any explanation or information, whether it has been given and whether it is satisfactory
- Whether or not the transactions of the banks, which have come to notice, have been within the powers of the banks
- Whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of the audit
- Whether the profit or loss a/c shows a true balances of the profit or loss for the period covered by such account; and
- Any other matter which he considers should be brought to the notice of the central government.

The report of the auditor of the nationalised bank is to be verified, signed, and transmitted to the central government. The auditor has also to forward a copy of the audit report to the bank concerned and to the RBI.

Regional rural banks
In the case of regional rural banks, the auditor has to report directly to the bank. the content of the report are similar to those of an audit report in the case of a nationalised banks. Apart from the audit report on the financial statements, the auditor of a nationalised bank, State bank of India, any of its subsidiary, or a banking company has also to prepare a longform audit report (LFAR). The auditor of the banks is also called upon to give reports and certificates on certain other specified matter.

6.12.5 Special Audit
In addition to the normal annual audit, a special of the banking company can be ordered by RBI under sec 30(1b) of the Banking Regulation Act. This power can be exercise by the RBI if it of the opinion that it is necessary to do so in public interest of the banks or in the of the bank or its depositors. The special audit is to cover the banks accounts, for the transaction or class of transaction or for such period or period as may be specified by RBI. For conducting special audit, RBI may either appoint a person who is qualified to act as a company auditor or the direct the statutory auditor of the bank to conduct a special audit. The section 223 of the Companies Act relates to the provisions of the special audit.

6.12.6 Approach to Banks' Audits
The guidance note on the audit of banks issued by the ICAI, recognise that the general approach to audit of banks involves essentially the same stages as in any other audits. However at each stage, the auditor has to take into the account the following special characteristics of banks:

- Custody of large volumes of monetary items, thereby requiring formal operating procedure, well-defined limits on the individual discretions and rigorous internal control.
- Large volume and variety of the transactions and continuing development of new products and services, many of which may involve complex accounting.
- Wide geographical dispersal of the operations with consequent difficulties in maintaining uniform operating practices and accounting systems, particularly in the case of the overseas operations.
- Significant commitments without transfer funds not requiring formal recognitions in the books of accounts.
- Special nature of risk with operations.
- A strict legal and regulatory framework that inter alia, influence the accounting and auditing.
6.13 Audit of Educational Institutions

Education has turned into a big business now. Apart from the Government controlled Schools, Colleges, Institutes and Universities, the entry of private sector into these areas have provided not only new opportunities to the Chartered Accountants who are in service, but have created an altogether new challenge to the Chartered Accountants who are in practice. Educational Institutions are very much different from the other business organisations and the process of audit of these Institutions is also very different.

Constitution

- Study the Trust Deed or any other similar document to ascertain the constitution of the Educational Institution.
- Make a note of the provisions contained in the regulations which may affect the accounts.

Minutes book

- Peruse the minutes of the meeting of the Governing Body making a note of the Resolutions affecting accounts.
- Ensure that the decisions taken have been duly complied with, for example, sanctioning of expenditure, operation of bank accounts, rejection of any financial proposal, etc.

Fees from students

- Check the names entered in the Students Fee Register for each month on term, with the respective class registers, showing names of students on rolls and testing amount of fees charged.
- See that the system of internal check ensures that demands against the students are properly raised.
- Verify fees received by comparing counterfoils of receipts given with entries in the cast book.
- Ascertain whether fees paid in advance have been duly considered under the sanction of an appropriate authority.
- Verify whether fines for late payment, absence, etc., have either been collected or remitted under proper authority.
- Verify admission fees with admission slips signed by the Principal of the Institution and confirming that the amount has been credited to a capital fund or separate account if decided so by the Governing Body.
- Trace the total collections in the Fee Register to confirm that the revenue from this source have been duly accounted for.
- Ascertain whether hostel dues were recovered before students accounts were closed and their deposit of caution money refunded.
- Report any old heavy arrears on account of fees, dormitory rent, etc., to the Governing Body or Management Committee.

Other income

- Verify any Government or local body grant with the memo of grant. Ascertain the reasons if any expenses have been disallowed for purpose of grant.
- Vouch the income from endowments and legacies, as well as interest and dividends from investment. Verify the securities in respect of Investments held.
- Verify rental income from landed property with Rent receipt and Agreement.

Expenditure

- Ascertain the operation of internal control system over various heads of expenditure.
- Vouch various expenditure items, noting abnormal or heavy items, if any. Obtain suitable explanation for significant items of expenditure.
Taxation
- Verify whether the Institution enjoys tax exemption under Income-tax Act.
- Examine whether the conditions subject to which exemption has been granted, have been followed.
- In case of TDS from Rent, Interest, etc., see whether refund claim has been made.

General
- Verify the fixed assets and ensure the adequate depreciation is provided.
- Verify the Capital Fund and other liabilities.
- Note that the investments representing endowment funds for prizes are kept separate and any income in excess of prizes has been accumulated and invested along with the corpus.
- Confirm that caution money and other deposits paid by the students on admission, have been shown as liability in the balance sheet and not transferred to revenue, unless they are not refundable.
- Ensure that separate statement of accounts have been prepared as regards Scholarships, Games Fund, Hostel Fund, Library Fund and P.F., etc.
- Verify whether the form and manner of presentation of financial information conforms to relevant Accounting Standard, if any and other applicable legal requirement.
- Obtain appropriate representation and certificates from the Competent person appointed by the Governing Body or Management Committee in respect of various aspects covered during the course of audit.

6.14 Audit of Insurance Companies
An insurance audit is often conducted on behalf of insurance companies that issue worker’s compensation, general liability and risk insurance policies. If you are a business owner or independent contractor, you may be subject to an insurance audit to verify policy eligibility or to ensure you are paying the correct premiums for the type of policy you own. An insurance audit checklist is a number of potential items you should have handy during your audit.

Corporation paperwork
Include all documentation related to the formation and operation of your business, sole proprietorship, limited liability company or corporation as applicable. Documents may include the articles of incorporation, corporate bylaws, business registration or business license, partnership agreements or LLC filings and operating agreement. Provide a list of all partners, owners, directors and board members in addition to their contact information and the relevant ownership percentage held by all entities.

Business details
Prepare a summary of the business operations such as the services that are provided by the business, what percentage of business operations could be considered foreign or domestic and the length of time business has been conducted. Create a list of all employees with their dates of employment, job titles and work responsibilities.

Payroll
Create a payroll summary that corresponds to the audit period. You may be asked to adhere to specific requirements depending on the insurance auditor’s preferences. Some auditors ask for copies of employee W-2 or contractor 1099 records, while others may prefer to see payroll ledgers or monthly or quarterly records generated by computerised accounting software.

Insurance certificates
If your business worked with independent contractors during the audit period, include copies of their insurance certificates in your audit documentation. A contractor conducting work at your place of business or on behalf of your company may be included as a liability on your policy if he is found to be uninsured during an insurance audit.
Financial records
In addition to payroll records, prepare a copy of your company’s financial records such as the total sales figures or invoices for the audit period. Include tax records such as quarterly 941 forms or other relevant tax records. Provide a list of all company assets such as land, buildings, inventory and company vehicles. Notate the current market value of each asset in addition to any methods that are currently in place to protect those assets such as a building alarm system, security cameras, fire protection and monitoring systems or security guard patrol.
Summary

- Audit plays a pivotal role in keeping proper legal check on those who carry on the business in a fiduciary capacity.
- For company accounts to be credible they must be true and fair and this is more likely to happen if someone competent and independent of the company has vetted the accounts.
- The statutory auditors are often described as the watchdogs of the company. They have access to the book of accounts, vouchers and documents, which no member of the company has.
- When the auditor reports to the shareholders expressing satisfaction, his opinion serves as an assurance that everything relating to accounts is in order in the company.
- A company may be registered any time during the year and, therefore, its date of registration may differ from the date of commencement of its normal accounting year.
- A statutory auditor is not appointed on a permanent basis. It is normally an annual assignment.
- The first auditors of a company appointed by its Board of Directors can be removed at a general meeting by an ordinary resolution of which a special notice is given.
- The normal expectation from the auditor, therefore, is to express an independent judgement on the results and financial position of the company, free from any pressure which the management or owners of that company might seek to exert.
- The Audit report contains the findings identified by the Auditor in the data checked by him and he gives his opinion on the quality of the data.
- The audit of the banks should be well-acquainted with the relevant provision of the special enactment that govern different types of banks, particularly those which affect the various items of the financial implications of the business carried on by banks and the types of the transaction that arise in the day-to-day operations.
- Educational Institutions are very much different from the other business organisations and the process of audit of these Institutions is also very different.
- An insurance audit is often conducted on behalf of insurance companies that issue worker’s compensation, general liability and risk insurance policies.

References


Recommended Reading

Self Assessment

1. ________, mandatory for all companies, is one of the regulatory mechanism designed to check abuses and irregularities in the financial aspects of the companies.
   a. Internal auditing
   b. External auditing
   c. Statutory auditing
   d. Financial auditing

2. Section __________ of the Companies Act, 1956 describes the qualification of a company auditor.
   a. 226 (1) and (2)
   b. 226 (1)
   c. 226 (2)
   d. 226 (3)

3. Section __________ of the Companies Act, 1956 describes the disqualification of a company auditor.
   a. 226 (1) and (2)
   b. 226 (1)
   c. 226 (2)
   d. 226 (3)

4. The auditor to be appointed for this initial and partial period of the company is known as the __________.
   a. first auditor
   b. second auditor
   c. third auditor
   d. forth auditor

5. Who is not appointed on a permanent basis and normally works on an annual assignment?
   a. Internal auditor
   b. Statutory auditor
   c. First auditor
   d. External auditor

6. The duties of a company auditor can be divided into ______ categories.
   a. two
   b. three
   c. four
   d. five

7. Which of the following dividend is recommended by the board?
   a. Final dividend
   b. Proposed dividend
   c. Interim dividend
   d. Stock dividend
8. Proposed dividend, when consented to by the shareholders at the annual general meeting becomes ________.
   a. final dividend
   b. proposed dividend
   c. Interim dividend
   d. stock dividend

9. Which of the following dividend is declared in between two AGM?
   a. Final dividend
   b. Proposed dividend
   c. Interim dividend
   d. Special dividend

10. Match the following.

<table>
<thead>
<tr>
<th></th>
<th>Unqualified opinion</th>
<th>A. an auditor is unable to complete an accurate audit report</th>
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<tbody>
<tr>
<td>2</td>
<td>Qualified opinion</td>
<td>B. the worst type of financial report that can be issued to a business</td>
</tr>
<tr>
<td>3</td>
<td>Adverse opinion</td>
<td>C. include an additional paragraph that highlights the reason why the audit report is not unqualified</td>
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<td>4</td>
<td>Disclaimer of opinion</td>
<td>D. Often called a clean opinion</td>
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a. 1-D, 2-C, 3-B, 4-A
b. 1-A, 2-B, 3-C, 4-D
c. 1-B, 2-D, 3-A, 4-C
d. 1-C, 2-A, 3-D, 4-B
Chapter VII
Audit of Non-profit Companies and Fraud Detection

Aim
The aim of this chapter is to:

- introduce non-profit organisations
- explicate auditing of non-profit companies
- describe the legal framework of auditing of non-profit organisation

Objectives
The objectives of this chapter are to:

- elucidate non-profit audit committee charter
- explain the concept of fraud
- explicate the characteristics of fraud and error

Learning outcome
At the end of this chapter, you will be able to:

- enlist the types of fraud
- understand the auditor’s responsibilities in finding fraud
- define critical issues related to auditing of non-profit organisation
7.1 Audit of Non-profit Organisations

All over the world, Not-for-Profit Organisations (NPOs) play an important role in the socio-economic process of the countries in which they operate. This is true not only in developing countries, but also in developed countries. NPOs in the South Asian Region are no exception. These organisations are important players in both the social and political spheres.

In recent years there has been a substantial expansion of NPO presence in the Region. A considerable sum of funds, received from both national and international sources is handled by these NPOs. This situation has been further enhanced by the Tsunami of 26th December 2004 etc., which resulted in an unprecedented inflow of financial and other resources in to the Region with many more such organisations.

Legal framework

The magnitude of the funds channelled through these organisations creates considerable responsibility in terms of follow up, monitoring and accountability. Transparency thus becomes an important issue. It is claimed that the statutory and regulatory environment is vague in the countries in this Region. Clear guidelines need to be provided to these organisations on how to conduct their affairs, including accounting and reporting. It is also acknowledged however, that extensive regulation is not necessarily fruitful, and that “too much” regulation might turn out to be equally as bad as “too little”, considering the important role that these organisations play within society at large.

7.2 Accounting and Auditing in not-for-profit Organisations

Many of the accounting standards have been made applicable to Not-for-Profit Organisations. Research Committee of the Institute of Chartered Accountants of India (ICAI) has recently brought out a research publication ‘Technical guide on Accounting and Auditing in Not-for-Profit Organisations’ elaborately explaining applicability of various accounting standards and other matters concerning accounting and auditing in such organisations. Though belated, it is indeed very praiseworthy on the part of the ICAI through its Research Committee to bring out this publication for the benefit/guidance of the members. There are not many authoritative guidelines in the area of accounting for NPOs up until now except for piecemeal efforts covering limited/local problems. As can be expected in the first major effort in this direction, the discussions in the technical guide, however, appear to be insufficient/incomplete in many areas and incorrect in some cases. Following are some of the important observations, calling for immediate review and improvement in the publication:

Registration under various central/state-level legislations

Many of the provisions of the central and state-level laws overlap in their application to not-for-profit organisations and registration of a charitable organisation under a particular enactment, central or state, does not necessarily make the organisation escape from other enactments. In States like Maharashtra and Gujarat, even if an organisation is registered under any enactment, say, S. 25 of the Companies Act, 1956, the provisions of the Bombay Public Trusts Act, 1950 are attracted if the organisation carries on public charitable or religious activities. [S. 2(13) of the Bombay Public Trusts Act, 1950].

No mention is seen of a company incorporated under the Companies Act, 1956 in the definition of ‘public trust’ u/s.2(13) of the Bombay Public Trusts Act, 1950. In the case of Akhil Deshastha Rigvedi Brahmin Madhyawarti Mandal v. Joint Charity Commissioner, Bombay, (1971) 74 Bom. L.R. 337, 340 : A. 1972 313, 315, 316., the Mandal was a company limited by guarantee incorporated under the Indian Companies Act, 1913, (and now under the Companies Act, 1956) under a licence from the Central Government u/s.26 of that Act, (corresponding to S. 25 of the Companies Act, 1956) and it was held that the Mandal, though incorporated as company, is also a trustee for its property and beneficiary was the community. Therefore, the Mandal constituted a ‘public trust’ and requires registration under the Bombay Public Trusts Act, 1950. Such overlapping applicability is to be kept in mind in formulation of accounting and auditing norms. This important issue does not find its discussion or mention in the technical guide.
Applicability of accounting standards
There is a strong undercurrent of commercial considerations in all the accounting standards made applicable to different businesses or other entities. Detailed examination of each accounting standard from the point of view of its applicability by taking into account the basic charitable/religious nature of the objects of the Not-for-Profit Organisations is necessary before making application of the accounting standards mandatory to Not-for-Profit Organisations (NPOs). Application of accounting standards as they are, if at all they are to be applied, without appropriate modifications/changes to suit NPOs, leads to many difficulties of interpretation and defeats the basic objective, as is illustrated in discussions below:

Accounting Standard 3 regarding cash flow statements
The most important and prime source of cash flow in case of an enterprise is its operating activities. The basic objective of the cash flow statement is ‘to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows’. The operating activities of the Not-for-Profit Organisations (NPO) do not, in most cases, generate cash nor are they meant to generate cash, as in case of any commercial enterprise. In cases of NPO in fact, the whole process of cash flow moves in the reverse direction. Cash/cash equivalents flow in first and thereafter the operating activities are decided, depending upon the availability of the funds with the NPO. The applicability of the accounting standard to NPO, therefore, loses its meaning and purpose. The recommendation in the technical guide to apply the standard needs a review.

AS 5 regarding net profit or loss for the period, prior period items and changes in accounting policies
The main objective of the first part of the accounting standard is meant to help determination of correct ‘net profit or loss’ of an enterprise for the period which ‘enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises’. An NPO does not earn profits nor incurs losses. NPO utilises funds for its objects, whether on account of current year or prior period, which might result in surplus or deficit for the year. Errors and omissions of earlier year/s may have a direct bearing on the profits or losses of a commercial enterprise for a particular year, but its impact on determination of utilisation of funds by an NPO during a particular year and consequently on surplus or deficit for the year is not relevant. In the process of execution of projects/activities by NPOs, the period covered may at times be more than a year and in some cases it may extend to several years. Accounting in such cases would be project-wise and not necessarily period-wise. The results, therefore, are to be viewed in a different perspective. NPOs generally operate in an independent environment of their own and comparing of their financial statements also is absurd. Applicability of accounting standard loses its basic objective and becomes irrelevant.

AS 10 regarding accounting for Fixed Assets
Assets held by NPOs are of many categories with different characteristics as to ownership titles. Some such categories of assets are explained below:

- Government land provided free of cost to NPO with or without conditions as to their use.
- Non-monetary assets such as land, building and other assets acquired free of cost, or acquired at a concessional rate with or without conditions, as to their use.
- Assets purchased out of own funds of NPO.
- Assets purchased out of restricted funds for use during execution of specific charitable projects as per sponsor’s directions, exclusively used for such purposes during the duration of the said project execution. Such assets, after the completion of the project could be attached with conditionality as to their ownership or could become absolute own assets of the NPO. It is also possible that such assets are of no use or of limited use to the NPO for its own purposes, after completion of the project though the asset per se is valuable and usable. Assets such as furniture, computer, vehicles, etc. are valuable and usable to the NPO even after the completion of the projects, if no condition as to return of the asset to the sponsor is specified in the sponsorship agreement.
- The legal ownership of the assets, continues to remain with the sponsors in a long-duration agreement with the NPO, but the beneficial possession and usage remains with the NPO.
- Assets acquired, partly funded by donors and partly out of own funds.

The technical guide does not cover various categories of assets discussed as above.
Technical guide prescribes two methods covering assets acquired free of cost and assets acquired at concessional rate/assets purchased. Reference is made in the technical guide to AS 12 regarding Accounting for Government Grants to specify that assets acquired as non-monetary grants free of cost should be accounted for at a nominal value (for example, Rupee one) with additions for incidental costs of acquisition, if any. As regards other assets, it is specified that the expenditure incurred on acquisition of the assets along with incidental expenses, if any, is to be accounted for.

Application of AS 12 to NPO, originally introduced for application to profit-making commercial organisations, will lead to many contradictions as highlighted below:

- NPOs operate under totally different environment and their accounting requirements and norms will have to suit that environment.
- The main sources of funds for NPOs generally are grants and donations and not profits from operations, with government grants making exception. Government grants and donations are the rule and earning profits is exception for NPOs.
- Various endowment laws govern such grants and other receipts apart from the Companies Act, 1956 and compliance of such laws with regard to accounting procedures and norms is unavoidable to NPOs.

AS 12 is meant for commercial, profit-earning enterprises, and therefore, cannot be made applicable to NPO without modification. Donations could be in cash or in kind and it should make no difference to an NPO if it is one or the other as far as accounting goes. Cost of donated asset to an NPO is the cost of such asset in the market, except that such asset is funded by a grant or donation and it is imperative to NPO to account for such grant as a grant in kind and the related asset as an asset. If a cash donation of, say, Rs.10 lakhs is given to an NPO for purchase of a building, the donation will be accounted for as donation and building purchased out of the said donation will be accounted for as building. If instead of cash donation, the donor buys a Rs.10 lakhs worth building and gives it free of cost to NPO, it will be accounted for at nominal value, say Re.1, if recommendation of technical guide is to be followed. This apparently is not what is intended.

Further, provisions of Bombay Public Trusts Act, 1950 read with Bombay Public Trusts Rules, 1951 also leave no option to an NPO in Maharashtra and Gujarat, but to account for both donations in cash or in kind at their correct/current value. The provisions of the Act as applicable to Maharashtra/Gujarat, prescribe disclosure of donations in kind, in the accounts. The forms of accounts vide Rule 17(1) specifically provide for separate disclosure of such donations. Contributions payable to the Charity Commissioner, as provided in the BPT, Act, 1950 u/s.58 and Rule 32 of the BPT Rules, 1951 do not exempt donations in kind and consequently, valuation of such assets at Re.1/- may be seen as under valuation for the purpose of avoiding BPT levy. There are, however, exemptions in case of Govt. grants and grants from other NPOs that can be availed to avoid the impact of BPT levy.

As regards assets described in items (iv), (v) and (vi) above, no clear-cut guidelines are prescribed in the technical guide. To value and account for such assets in the manner explained in accounting standard 10 will cause a lot of inaccuracies and contradictions in disclosure of the NPO’s final accounts.

In case of project-specific assets purchased out of grants given for execution of a specific project as stated in (iv) above, the value of the asset will be an expenditure for the project during the duration of the project and thereafter, it may become NPO’s asset or a community asset to be handed over to the beneficiaries of grant for future use or it may revert back to the sponsor of the project, as per the condition of the grant. In case the asset becomes community asset for future use of beneficiaries or reverts back to the sponsor, the question of accounting it in NPO’s books does not arise after the expenses are charged off as project expenses. In case the asset becomes part of NPO’s assets on completion of project, it is necessary to ascertain whether the said asset is useful to the NPO in its day-to-day operations and if so, what is its current value to be considered for accounting in the books. If the asset is not useful to the NPO, but the same is valuable, it may be recorded in the books at Re.1 and if on the other hand the asset is useful to the NPO, the same could be recorded on a technical evaluation and brought to books as addition of that year. Impliedly, this also could be considered as a non-monetary grant received free of cost in the year of completion of the project as per recommendation in AS 10, but due to reasons explained earlier, valuation at its current value would be more correct and proper.
Accounting Standard 6 regarding Depreciation Accounting:
The significance of charging depreciation in case of an NPO will differ from NPO to NPO, depending upon the nature of objects for which they are established. If activities are research oriented, wherein use of expensive equipment/tools is involved, the charging of depreciation thereon to ascertain correct utilisation of fund for research becomes unavoidable. Whereas, if an NPO exists for religious purposes or for famine and medical relief or for other services in which acquisition and utilisation of assets may not be of significance and activities may be service oriented and may not involve use of assets, in such cases, one-time purchase of building and related furniture for office use and purchase of vehicles for day-to-day travel in pursuance of organisation’s objects do not call for mandatory charging of depreciation.

It may be noted that charging of depreciation is not made mandatory by various State laws, such as Bombay Public Trusts Act, 1950 or Societies Registration Act, 1860 and the rules prescribed therein as are applicable in several States and charging of depreciation in such cases is only optional. When the accounts are prepared as prescribed under those statutes, non-compliance of the mandatory accounting standard 6 regarding depreciation will have a place only in the auditor’s report, as was the case when accounting standards prescribed by the ICAI were not mandatory under the Companies Act, 1956 prior to its recent amendment. In fact, the prescribed audit report format under the Bombay Public Trusts Act, 1950 does not even have a place for disclosure of such non-compliance, unless one makes modifications to prescribed format at one’s own liberty or inserts it under ‘special matters to be brought to the notice of the charity commissioner’.

Under the provisions of Income-tax Act, 1961 also, the significant aspect of the importance given to ‘utilisation of funds’ cannot be overlooked. Utilisation of funds in case of NPOs also includes cost of acquisition of assets, and depreciation is not separately considered. It is very significant to note that assets play a major role in the operations of a commercial organisation, such as plant and machinery in case of a manufacturing concern, and therefore, charging of depreciation to make up for cost of use of assets, is absolutely essential in determining the profit, whereas in most NPOs assets play no role or very insignificant role in day-to-day operations.

Even if Accounting Standard 6 for charging of depreciation is to be made mandatory to NPOs, it is improper to overlook the salient features of the statutes under which the NPOs operate, the environment under which they work, different characteristics associated with each asset as a result of its unique mode of acquisition, etc. as discussed in detail above.

Accounting Standard 12, accounting for government grants
The technical guide specifies that NPOs should follow the requirements of AS 12 in their entirety for both Govt. grants and grants from other donor agencies. The problem in applying AS 12 to NPOs, however, stems from the fact that the standard, which was originally prepared for application to a commercial organisation, is made applicable in to NPO. Various aspects of the grants, their special/distinct features, alternative treatment specified in other applicable laws would all have to be ignored at NPO’s own risk, if the provisions of AS 12 are to be applied in toot. Treatment suggested in AS 12, may be summarised as under:

- Grant given for acquisition of specific fixed asset should be shown in the balance sheet as a deduction from the gross value of the relevant fixed asset.
- Alternatively, the fixed asset should be disclosed at its gross value and the related grant, if received for non-depreciable asset, should be credited to capital reserve.
- If the grant relates to a depreciable asset, it should be treated as deferred income, which should be recognised in the ‘profit and loss account’ by allocating it over the periods and in proportions in which depreciation on the asset concerned is charged.
- Government grants having the characteristics of promoters’ contribution should be credited to capital reserve.
- Government grants in the form of non-monetary assets given at a concessional rate to be accounted for on the basis of their acquisition cost.
• Government grants in the form of non-monetary assets given free of cost should be recorded at a nominal value (for example, Rupee 1).

• Government grants received with reference to ‘revenue’ of the enterprise to be recognised on a systematic basis in the ‘profit and loss account’ over the periods necessary to match them with the related costs, which they are intended to compensate.

Commercial considerations far outweigh other objectives in the norms prescribed as above to enable determination of correct profits of an enterprise. It is the ‘revenue’ and ‘profits’, which are of paramount importance to a commercial enterprise, which call for the treatments prescribed in the AS 12. The technical guide suggests the following treatment based on treatment specified in AS 12 for Government grants in case of NPOs:

• The NPO should recognise grant/donation in its financial statements only at the stage it attains reasonable assurance that the grant/donation will be received.

• Non-monetary grants, whether as fixed or current asset, received free of cost or at a concessional rate should be recognised at nominal value or actual cost to the NPO.

• Grants to meet revenue expenses should be accounted for to the extent utilised during the period and the relevant expense should be disclosed separately in the Income and Expenditure Account. This, in other words, means that the funds remaining unutilised by the NPO out of expense, specific grant and held by it at the year-end shall be disclosed as liability to the donor pending its utilisation by NPO.

While one may not have any difference of opinion regarding the applicability of suggestions as given in 1 and 3 above, the method specified in 2 above requires complete review. NPOs survive mainly on grants and donations, and all grants and donations, whether monetary or non-monetary, are required to be accounted for at their original value. Stress is on ‘receipt/income’ and not on ‘revenue’.

No accounting standard has been prescribed by ICAI or other authorities, for accounting of receipts for sponsored projects by NPO. Prescribing a standard, in fact, is not possible because in many cases, sponsorships have their own terms and conditions and unique/special features applicable to specific projects. Examples are: only partial sponsorship for acquisition of the asset (part shortfall of cost is met by NPO); ownership of the asset to remain with sponsor even after the completion of the project, return of the assets of the project to the sponsor after the completion of the project etc. Under such circumstances, the best-suited method is to be evolved taking into account the needs of the situation. Depending on the size and nature of operations, it may be different from NPO to NPO.

Funds provided by the sponsor for project assets acquired, are not covered by the type of grants (Government grants) explained in AS 12. These are the assets purchased primarily for use in the projects for which they are purchased. Grants are project-specific grants given under a sponsorship agreement and not asset-specific grants as envisaged in the AS 12. Grant is not received as grant for the NPO for its use. Until the project is completed as per the terms and conditions of the agreement, the asset is that of the project and cannot be treated as belonging to the NPO. Cost of the asset is treated as part of the project expenditure. It is only when the project is completed and the asset remains with the NPO without any pre-conditions in sponsorship agreement as to ownership of the NPO that the asset enters the books of the NPO. At that point in time, the said asset becomes a kind of ‘donation in kind’ and the same will have to be accounted for accordingly. Valuation of such an asset will have to be on an estimated basis, based on its condition and future use to the NPO.

Assets like vehicles, land and buildings, office equipments, etc., get grossly undervalued in the books if they are valued at Re.1/- and not at their correct value. The true and fair view of the balance sheet gets affected. An NPO may be holding substantial properties mostly donated or granted and if those are to be valued at Re 1 each as suggested, it will not only be contrary to the provisions of various local endowment laws, but also that the values at which they are disclosed will not be true and correct. The donations and grants, including those received in kind as well as at concessional rate, will have to be accounted for as such in the year of receipt in case of an NPO and the concerned asset will have to be recorded in the books of NPO at its correct and real value.
AS 17 segment reporting
This is another accounting standard, which does not by intent appear to be applicable to an NPO. At the most, this can only be applied to an NPO running a business. This cannot even be applied if business activity is only incidental in pursuing the main object of the NPO, which is charitable and not linked to such income. An NPO does not have a ‘business segment’ nor does it subject itself to ‘risks and returns’ that are linked to ‘products and services’.

The Institute of Chartered Accountants of India made segment reporting mandatory with effect from 1-4-2001 for disclosure in the final accounts in case of enterprises whose equity or debt securities are listed and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange of India and to all other commercial, industrial and business reporting enterprises whose turnover for the accounting period exceeds Rs.50 crores.

It is obvious that an NPO does not fall in any of the categories mentioned above and, therefore, there is no statutory/ICAI compulsion for such disclosure in Final Accounts. Even otherwise, segmentising NPO activities either geographically or business-wise (activity-wise) as required under Accounting Standard 17 for Segment Reporting appears out of context.

Accounting standard 18, related party disclosures
Applicability of this accounting standard in an NPO environment is again an invalid proposition. NPO doesn’t operate for profits nor does it operate in a business environment, wherein relationships could lead to financial ties to the mutual benefit of the parties to business. In the case of an NPO, a related party transaction will not have any bearing on the working of the NPO. The technical guide states “...for the purposes of AS 18, trustees of an NPO would be considered as key management personnel and, accordingly, trustees and their relatives would, inter alia, be treated as related parties”. When the basic profit motive is missing in the working of an NPO and the entire operation is with a charity motive, the related party transactions between related parties of trustees/office bearers of NPO and the NPO will not have any financial implications to the NPO. The disclosures, if made as suggested, will be just bland disclosures without any meaning or purpose. The trustee/manager of an NPO operates on trust for the benefit of public at large. He does not have, nor is supposed to have, any personal interest in trust properties or its financial transactions. He is not the owner of the trust property, but only a trustee working under the overall supervision/control of prescribed authority, say, Charity Commissioner/Registrar of Societies.

Without going into details and merits, perhaps one can say that ‘related party transactions’ as understood in commercial parlance is missing in NPO transaction and, therefore, need not apply in its existing form. It may further be mentioned that as in case of AS 17 above, the applicability of the Accounting Standard 18 is restricted to enterprises whose equity or debt securities are listed and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange of India and to all other commercial, industrial and business reporting enterprises whose turnover for the accounting period exceeds Rs.50 crores. It is again apparent that an NPO does not fall in any of the categories mentioned above and, therefore, there is no statutory/ICAI compulsion for such disclosure in Final Accounts.

Accounting Standard 21, consolidated financial statements
While discussing the applicability of AS 21 to NGOs, the technical guide states that if an NPO controls another enterprise (organisation), either through ownership of more than one-half voting power or through control over governing body, the NPO would be considered as parent and the enterprise that is controlled by the NPO would be a subsidiary. The technical guide goes on to prescribe that the NPO should prepare and present consolidated financial statements in accordance with the requirements of AS 21.

It is apparent that the following important aspects of NPO environment are to be kept in mind before the accounting standard is specified for application by NPOs:

- AS 21 specifies that an enterprise that presents consolidated financial statements should prepare and present these statements in accordance with this standard. In case of different and independent NPOs, however, there is no need for preparation of consolidated financial statements either for statutory purposes or otherwise, even if managing committee consists of common trustees/members. What is important to note is that AS 21 will be applicable if for any reason the Parent NPO, which controls other NPOs, voluntarily prepares consolidated financial statement.
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- AS 21 defines ‘Control’ between two enterprises as “(b) control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in the case of any other enterprise so as to obtain economic benefits from its activities.” It is very apparent that NPOs do not operate for their own economic benefits or economic benefits of other NPOs. There is, therefore, no question of one NPO deriving economic benefit from another NPO (parent or otherwise) even if governing body consists of common trustees/members making two institutions ‘related’ technically. The basic objective of the standard is defeated and as a result, the application of the standard to an NPO appears redundant/absurd.

Accounting Standard 22 — Accounting for taxes on income
NPOs by nature of their activities and the objectives for which they exist are tax exempt, of course, subject to compliance of certain conditions specified in the Income-tax Act, 1961. But in no case one would expect them to pay taxes out of receipts from donations and grants for charitable purposes. The entire specification in the technical guide that ‘The requirements of this standard should be followed by NPOs in their entirety. Normally, some kind of exemptions is allowed to the NPOs from payment of income tax due to the nature of their charitable objects and non-profit motives. Such exemptions allowed to the NPOs under Income-tax Act, 1961, could be considered as permanent differences for the purpose of AS 22.’ appear to be totally out of context. To say that some kinds of exemptions are available makes one feel that there is ignorance of the NPO set-up. By nature of their activities NPOs do not have ‘income’. It is by virtue of deeming provision under Income-tax Act, 1961 to encourage expenses on objects of NPOs, one is made to pay tax, provided expenses fall short of prescribed limits. The entire Para should be dropped and the standard should be made inapplicable.

Accounting Standard 23 — Accounting for investments in associates in consolidated financial statements
It is well known that NPOs are not allowed to ‘invest’ in any other modes than those specified in local laws, such as Trust Acts or Societies Acts as well as Income-tax Act, 1961. The entire tax exemption will be lost if the tax provisions in this regard are contravened. The penal consequences from local authorities governing such institutions, such as Charity Commissioners or Registrar of Societies could also follow. The NPOs, therefore, cannot make investments in associates as envisaged in AS 23. The question of NPO accounting for investments in associates in the consolidated financial statements, therefore, does not arise. The standard is not applicable to NPOs and the technical guide needs to be appropriately modified.

AS 24 — Discontinuing operations
For the purpose of this Standard, each major programme/project carried on by the NPO may be considered as a separate major line of business.’ Considering activities/projects carried on by NPOs as ‘line of business’ is not comprehensible. Disclosure of the discontinuing operations in a business environment is significant. In case of NPOs, there being no business activity pursued, application of AS 24 appears out of place. NPOs normally undertake two types of charitable activities/projects, viz., on their own and on behalf of others on a reimbursement/sponsorship basis. Even assuming application of AS 24, if own activities/projects are discontinued, identifying whether such activities are major from the point of view of application of AS 24 is going to create difficulty in the absence of definition of ‘major programme’ in the technical guide. As regards activities carried on on behalf of others, the following practical aspects of project execution need to be kept in mind before AS 24 is made applicable to NPOs:

In the case of reasonably large NPOs, many projects, big and small, are taken up, executed and closed frequently on a regular basis in a time-bound manner. Starting and closure of projects, both big and small, are far too many and frequent in the routine course of working of an NPO to warrant disclosure as specified in AS 24. Accounting Standard 24 is not meant for application for such sponsored charitable projects. One may have to apply the standard to those activities the discontinuance of which may have a direct bearing on the working of the NPO as a ‘Going concern’. The definition of ‘major programme’ is also necessary without which application of AS 24 would be very difficult.

AS 27 — Financial reporting of interests in joint ventures
The technical guide prescribes that ‘NPOs should report their interests in such joint ventures in separate as well as in the consolidated financial statements (prepared as per AS 21) in accordance with the requirements of this standard.’ The joint venture is defined in AS 27 as ‘a contractual arrangement, where-by two or more parties undertake an
economic activity which is subject to joint control’. Provisions of various endowment laws under which the NPOs operate as well as provisions of Income-tax Act, 1961 under which the NPOs seek exemptions from tax, prevent NPOs from undertaking any economic activity whereby the NPOs derive profits. Investments in joint ventures for economic activity/benefits would be contrary to such exemption provisions. Joint venture in case of an NPO could only be under the following circumstances:

- Joint venture with another NPO to execute a common charitable activity, in which case the ‘interest’ as envisaged in AS 27 is absent in the joint venture between two NPOs.
- A joint venture business which is incidental to the attainment of the objectives of the NPO as a charitable institution allowed under Income-tax Act, 1961 and other endowment laws, provided separate books of account of such business are maintained and the income from such incidental business is used for the charitable objects of the NPO. AS 27 may be considered as applicable, though, even in such cases, treating joint venture as business activity as envisaged in AS 27 when the activity is only incidental to the charitable objects of the NPO, is not beyond doubt.

7.3 Non-profit Audit Committee Charter

The audit committee (“the committee”) of the board of directors (“the board”) of the non-profit organisation (“the organisation”) will have the oversight responsibility, authority, and specific duties as described below.

Composition
The committee will comprise three or more directors, as determined by the board.

Responsibility
The committee is part of the board. Its primary function is to assist the board in fulfilling its oversight responsibilities with respect to (1) the audit of the organisation’s books and records and (2) the system of internal controls that the organisation has established. The committee should have a clear understanding with the outside auditors that they must maintain an open and transparent relationship with the committee, and that the ultimate accountability of the outside auditors is to the board and committee. The committee will make regular progress reports to the board.

Authority
Subject to the prior approval of the board, the committee is granted the authority to investigate any matter or activity involving financial accounting and financial reporting, as well as the organisation’s internal controls. In that regard, the committee will have access to the organisation’s external professionals to render advice and counsel in such matters.

Meetings
The committee is to meet at least four times annually and as many additional times as the committee deems necessary. The committee chair should clear the content of the agenda for each meeting. The committee is to meet in separate executive sessions with the outside auditors at least once annually and at other times when considered appropriate.

Attendance
Committee members will strive to be present at all meetings.

Specific duties
In carrying out its oversight responsibilities, the committee will:

- Review and reassess the adequacy of this charter annually and propose changes to the board for approval.
- Review with the executive director and outside auditors the organisation’s accounting and financial reporting controls. Obtain annually in writing from outside auditors a letter regarding the adequacy of such controls.
- Review with the executive director and outside auditors significant accounting and reporting principles, practices, and procedures applied by the organisation in preparing its financial statements. Discuss with the outside auditors their judgments about the quality—not just the acceptability—of the organisation’s accounting principles used in financial reporting.
• Review the scope and general extent of the outside auditors’ annual audit. The committee’s review should include an explanation from the outside auditors of the factors considered by the accountants in determining the audit scope, including the major risk factors. The outside auditors should confirm to the committee that no limitations have been placed on the scope or nature of their audit procedures. The committee will review annually with the executive director the fee arrangement with the outside auditors.

• Inquire as to the independence of the outside auditors and obtain from the outside auditors, at least annually, a formal written statement delineating all relationships between the outside auditors and the organisation, including other consulting work being performed by the outside auditors for the organisation.

At the completion of the annual audit, review with the executive director and the outside auditors the following:

• Results of the audit of the financial statements and the related report therein and, if applicable, a report on changes during the year in accounting principles and their application.

• Significant changes to the audit plan, if any, and serious disputes or difficulties the executive director encountered during the audit. Inquire about the cooperation received by the outside auditors during their audit, including access to all requested records, data, and information. Ask the outside auditors about any disagreements with the executive director that, if left unresolved, could have caused them to issue a nonstandard report on the organisation’s financial statements.

• Other communications as required to be conveyed by the outside auditors by Statement of Auditing Standards 61, as amended by SAS 90, relating to the conduct of the audit. Further, receive a written communication provided by the outside auditors concerning their judgment about the quality of the organisation’s accounting principles as outlined in SAS 61 and amended by SAS 90, and confirm that they concur with the executive director’s representation regarding audit adjustments.

7.4 Fraud

In simple terms fraud is a mistake with a reason. To explain more Fraud is an activity by a person who does his duty in a wrong way or refrains from doing his duty for some favours, i.e., financial, tangible, or anything else which is not due to him or them in the normal course. In simple words fraud is an intentional abnormal activity for undue gains. Or Fraud as the name suggests refers to the intentional misrepresentation by employees or other persons related to business, it can be both for monetary or non monetary gains.

As a human being everybody has some immediate goal. For example for a hungry person global warming has nothing to do, he needs food as his first priority. Either he can steal it or do something to make it available. Given a free will he will just eat and go. If there is a person sitting there he may force and eat or work and it. Assuming that there is no law, based on his personal power he will force and eat. That is the jungle rule.

Today we all live in some or other society and we want to live happily. However, the jungle rule mentality of the people is not gone. It is there deep inside us. It is forced to sleep under the fear of, god, society, law and order. It wakes up when ever the fear elements are reduced or zero. With modernisation the human being has understood that same jungle rule can be played even now with the polish of knowledge. But as always it remains shot lived since somewhere or other it will be disclosed by another human having the same style and same mentality.

It is as if, it is the only thing known to the maximum of the man kind and all those people do it with the same intention, i.e., to gain something. Of course that is the reason they do it.

7.4.1 Characteristics of Fraud and Error

Misstatements in the financial statements can arise from fraud or error. The term “error” refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, such as:

• A mistake in gathering or processing data from which financial statements are prepared.

• An incorrect accounting estimate arising from oversight or misinterpretation of facts.

• A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.
The term “fraud” refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as “management fraud”; fraud involving only employees of the entity is referred to as “employee fraud.” In either case, there may be collusion with third parties outside the entity.

Two types of intentional misstatements are relevant to the auditor’s consideration of fraud—misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure

Misappropriation of assets involves the theft of an entity’s assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

Fraud involves motivation to commit fraud and a perceived opportunity to do so. Individuals might be motivated to misappropriate assets, for example, because the individuals are living beyond their means. Fraudulent financial reporting may be committed because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. A perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement in the financial statements is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult, if not impossible, for the auditor to determine intent, particularly in matters involving management judgment, such as accounting estimates and the appropriate application of accounting principles.

### 7.5 Types of Fraud

There are various trigger points for fraud. They are explained in the section below:

**Accidental Unintentional**

To err is human. If you work then you will definitely do some mistakes. This is a normal procedure for human beings. If the same is noted and rectified with or without declaring the same then the mistake becomes an error and a learning point. If the error is caught by another person and brought to the table, than again it will depend whether the person committing the mistake has gained anything due to this mistake and if yes, then whether the immediate employers or any other person in this planet has incurred any loss instantly or remotely. If both are confirmed as positive, then it can be termed as fraud irrespective of the person’s intention since it will be very difficult for him to prove otherwise. In such a case, it becomes very hard for a person to explain and prove that it was not fraud and he is honest.
But if unintentional mistake committed by one person is not caught by any other person and if the person committing the errors learns to use the same mistake for making money or other favours, then the classification changes and the same error becomes a fraud.

**Planned Fraud**

Planned fraud is again divided into two categories. A single person planning and executing the whole fraud this can be controlled to some what extent, by efficient internal controls where every transaction goes through multiple levels and authorities. However due to saving on employees cost we become very much susceptible to such fraud.

- **A Group of People:** This category is famous for even killing all the internal controls. Where an outsider only can do something may be a private investigator. But all the organisations cannot really afford to put some undercover agent in the working floor due to the cost factor. Even though it is seen that some companies do this, where the promoters interest is very high. Further these type of frauds never comes out unless otherwise an outsider or perpetrators themselves disclose the same. Proper Record keeping and monitoring of employees by some trustworthy outside agency can help to some extent. Whether done or not the employment letter should get their legal permission just to make them aware of the fact that this is being regularly done by the employer.

- **Forced Fraud:** Some good people also get involved with the fraudsters innocently and then of course get punished too. Blackmailed people are such instances. They committed an innocent or illegal act and got caught by these famous fraudsters and then get used by them. Fear is one of the most driving agents, since some people get involved for the sake of saving their job, family, friends etc. Usually these people are the weakest links in the whole chain and often disclose the whole chain of fraudulent activities.

### 7.6 Preventing Fraud

Fraud in any form affects somebody or other, instantly or remotely and is one of the biggest problems that are faced by the mankind. It is, as if the only thing known to the maximum number of people in some form or other and all those people do it with the same intention, i.e., to gain something. Of course that is the reason they do it. Fear can be of any type, but the fraudsters should know that they will be caught irrespective of their position and power.

Normally we try to prevent fraud by implementing internal control systems in our business and our surrounding, but everything is breakable since it is operated through human beings, and most people’s ethics are sold or bought at the right price. Internal controls to work efficiently needs to be updated regularly based on the new developments for which again it should be monitored on a continuous basis. There is no one formula which may suit all business, since the fraud detection techniques also need a continuous update. However, some are listed:

- **Evaluation of all internal control:** There should be regular evaluation of all internal controls which are specifically prone to fraud risk. A responsible person should be nominated to keep and eye on the controls where it is easy for someone to commit a fraud. Area where cash handling is involved is particularly prone to frauds.

- **Check on business assets:** A good business man is one who keeps a control on his assets and liabilities. It is necessary to keep an inventory of all business assets at regular intervals, so that no misappropriation like theft, pilferage etc can take place. Regular stock take and physical verification of the assets will deter employees from theft.

- **Keep check on the code of ethics or conduct of your employees:** Businessmen should keep a check on their employees conduct and from time to time they should keep a note of their behaviours especially if they are related to financial transactions area. The best practice is definitely training and setting examples. Employees involved in accounts payable functions or purchasing functions and any employee who submits expense reports are the most susceptible to fraud. Training these individuals, as well as all employees, on company policies, procedures and code of conduct is imperative. Accountability plays a large role in deterrence. When employees realise the company will take a hard stance on fraudsters, they will think twice about committing an abnormal act, i.e., fraud.

- **Check on illegal acts:** Every act of an organisation matters, a single illegal act can affect the business and may destroy its reputation and goodwill in the market. Therefore, it is imperative for the owners to be sure that no illegal acts are taking place in their organisation. Especially in wide spread business houses it should be ensured that the responsibility is fixed on the chief-in-charge for the place, to ensure that no violation of the local statute is being done at his place.
• Auditors recommendations: Both statutory as well as internal auditors are third party person who are independent from your business and hence do not have any vested interest in the business, hence any finding by them should be taken very seriously as these are professional people who have in depth knowledge of their subject and can add substantial value to your business. However this is applicable when management other than top management is committing the fraud.

• Review of audit committee: Audit committee is one key source which outlines the major issues of your business. Management should seriously take the recommendations and reviews made by the audit committee.

• Maintain adequate business procedures for handling complaints: most of the times frauds are brought to the notice by employees who do not want to appear in public. So it is necessary that there should be some mechanism in the organisation for the employees to anonymously report any complaints or information that they may have. A complain box or hotline can effectively serve this purpose.

• Now days there are so many software companies who have designed products that perform fraud tests on real-time, daily transactions. They can also conduct tests on company’s last one or two year’s data just by attaching the same.

7.7 Auditor’s Responsibility in Finding Fraud

Internal auditors support management’s efforts to establish a culture that embraces ethics, honesty, and integrity. They assist management with the evaluation of internal controls used to detect or mitigate fraud, evaluate the organisation’s assessment of fraud risk, and are involved in any fraud investigations.

Although it is management’s responsibility to design internal controls to prevent, detect, and mitigate fraud, the internal auditors are the appropriate resource for assessing the effectiveness of what management has implemented. Therefore, depending on directives from management, the board, audit committee, or other governing body, the internal auditors might play a variety of consulting, assurance, collaborative, advisory, oversight, and investigative roles in an organisation’s fraud management process.

Competent professional internal auditors are highly proficient in techniques used to evaluate internal controls. That proficiency, coupled with their understanding of the indicators of fraud, enables them to assess an organisation’s fraud risks and advise management of the necessary steps to take when indicators are present.

Prevention

Establishing a culture of integrity is a critical component of fraud control. Executive management must set the tone at the top and model the highest level of integrity. The internal auditors may advise management on methods to ensure integrity and may become involved in communicating or interpreting those methods. They also may help develop training related to integrity policies and fraud.

As a part of their assurance activities, internal auditors watch for potential fraud risks, assess the adequacy of related controls, and make recommendations for improvement. They also can help benchmark statistics related to the probability of occurrence and consequences of fraud.

Detection

Because the internal auditors are exposed to key processes throughout the organisation and have open lines of communication with the executive board and staff, they are able to play an important role in fraud detection. In many organisations, the chief audit executive (CAE) is responsible for responding to issues raised on the ethics hotline or through another process that may lead to detection of fraud.

When developing their annual audit plan, the internal auditors consider the organisation’s assessment of fraud risk, and periodically might make assessments of management’s fraud detection capabilities. They design tests that use audit techniques like data mining to ensure the controls in place are effective.
Investigation

Internal audit skills relate to gathering evidence, analysing the breakdown in controls that could enable a fraud, and making recommendations for improvement. And reporting directly to the board or governing body provides the internal auditors with a level of independence and objectivity necessary for them to undertake investigations of a sensitive nature.

Although the internal auditors may either have a direct role in investigating fraud incidents, or act as a resource to those responsible, they generally are not expected to have the expertise of those whose primary responsibility is detecting and investigating fraud. When the internal auditors have the primary responsibility for fraud they must have the key competencies for this work - typically obtained through specialised training and related experiences. They also may be certified as fraud or forensic investigators.

7.8 Clauses of Fraud in Auditing in India

Concerns of audit effectiveness were raised in India too, and the auditor’s role and CARO and ICAI’s auditing standards have been revised. The relevant clauses of these pronouncements have been examined below:

Auditing Assurance Standard — AAS 4

This is a specific auditing and assurance standard pronounced by the ICAI (effective from April 1, 2003), relating to an auditor’s duty as regards ‘fraud and error’ in financial statements. This standard state that the primary responsibility for the prevention and detection of fraud and error rests with both: (1) those charged with governance, and (2) the management of an entity. The standard also spelt out the auditor’s enhanced responsibility and laid down expectations of a far more penetrative audit than ever before in the past. The salient features of this AAS 4 are:

• An attitude of professional skepticism. No longer can an auditor rely merely on any management representation. In effect, he must obtain evidence that either agrees with, or, brings into question the reliability of management representations. An auditor must adopt, necessarily, an attitude of professional skepticism that will enable him to identify and properly evaluate matters that increase the risk of a material misstatement in the financial statements resulting from fraud or error. He now has to examine and question the management’s influence over the control environment, industry conditions, and operating characteristics and financial stability.

• Importance of teamwork in conducting an audit. The standard also expresses the importance of teamwork. In planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error.

• Perform additional, extended or commensurate audit procedures where fraud is suspected. When the auditor encounters circumstances that may indicate that there is a material misstatement in the financial statements resulting from fraud or error, the auditor should perform procedures to determine whether the financial statements are materially misstated.

• Reporting obligations. When the auditor identifies a misstatement resulting from fraud, or a suspected fraud, or error, the auditor should consider the auditor’s responsibility to communicate that information to management, those charged with governance and, in some circumstances, when so required by the laws and regulations, to regulatory and enforcement authorities also.

• Where an auditor has obtained evidence that fraud exists, even materiality is not a point for consideration for communicating this matter to the appropriate level of the management timely.

Thus, as per AAS 4, an auditor has to virtually move heaven and earth to satisfy himself while carrying out an audit, that no serious red flags exist. If they do exist, he has to necessarily apply appropriate procedures to confirm his suspicions or dispel his doubts, about the existence of fraud. In case there is evidence of fraud, then, even materiality is not a factor for consideration — the matter of fraud has to be communicated to the appropriate level of management on a timely basis and he has to even consider reporting it to those charged with corporate governance.
CARO also casts a significant responsibility on the auditor which has been considered next.

**Clauses of CARO relating to reporting of fraud by auditors**

Clauses 4(iv) and 4(xxi) of CARO are very important for auditors, especially with regard to their duty towards fraud. 4(iv) requires an auditor to report whether there are adequate internal control procedures commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods. What is significant is that the auditor is expected to report whether there is a continuing failure to correct major weaknesses in internal control. The key phrase is ‘continuing failure’. The continuing failure could stem from incompetence or fraud, but either way the auditor cannot ignore the possibility of existence of fraud. If he reports such a continuing failure but not a fraud, and if fraud is discovered later, the auditor may find himself in an unenviable situation to escape the responsibility for not carrying out appropriate audit procedures and also perhaps for not reporting the fraud. Clause 4(xxi) is even more serious, in that, it actually casts a direct responsibility on the auditor to report whether any fraud on or by the company has been noticed or reported during the year; if the answer is affirmative, the nature of the fraud and the amount involved have to be indicated. Here too, it is pertinent to note that materiality is not a factor for consideration by the auditor. If a fraud has been noticed or even reported, he has no choice but to report its nature and the amount involved. Furthermore, by virtue of being an auditor, and the very definition of audit as explained later, his duty does not end merely in mentioning that a fraud was noticed or reported; as an auditor his role automatically requires him to carry out an investigation and apply such other checks and verifications so as to enable him to be satisfied that the fraud is not isolated and that it does not have any other implications on the financial information he is expressing an opinion on.

Thus, CARO clearly spells out the duty of the auditor towards fraud detection and reporting.

**Sales Tax Practitioners’ Association (STPA) of Maharashtra v. the State of Maharashtra (Note 3)**

This case is also very relevant to this article because it examines the definition of audit and concludes that detection of fraud is of primary importance in an audit. While considering the petition of the STP (refer note 3 for details) the High Court examined the very definition of audit. After considering certain definitions, it concluded that the word audit has a specific connotation in the matter of examination, investigation and auditing of accounts, where detection of fraud is of primary importance. One of the definitions of audit referred to is that of R A Irish in his book ‘Practical Auditing’. It says that an audit may be said to be a skilled examination of such books, accounts and vouchers as will enable the auditor to verify the balance sheet. The main objects of an audit are: to certify the correctness of the financial position as shown in the balance sheet and the accompanying revenue statements, the detection of errors and the detection of fraud — the detection of fraud is generally regarded as being of primary importance. The High Court also observed “The object and purpose of compulsory audit is to facilitate the prevention of evasion of taxes, administrative convenience. It is a specialised job which can be undertaken only by a person professionally competent and trained to audit. Thus, auditors are expected to possess skills which could act as even a deterrent for tax evasion fraud. However, the High Court, also accentuated the risks accompanying the privileges: “The Chartered Accountant, by his very privileged status exposes himself to the consequences of civil liability for negligence, liability for professional misconduct in disciplinary proceedings under the Chartered Accountants Act, 1949, and sometimes to criminal liability under the Penal Code.”

Thus the above judgment clearly emphasises that an auditor’s role includes fraud and error detection and detection of fraud is of primary importance and that the auditor is exposed to severe penal consequences for non-performance of his duty.

**Insights from the O’Malley Report**

Thus far, this article has reviewed the auditor’s role within the domain of the Indian legislation and the ICAI’s pronouncements. The Panel made some important revelations about the auditor’s role towards fraud. The Panel recommended that auditors should perform some ‘forensic-type’ procedures on every audit to enhance the prospects of detecting material financial statement fraud. Audit work would be based and directed to detect and find the possibility of dishonesty and collusion, overriding of controls and falsification of documents.
Auditors would be required, during this phase, in some cases on a surprise basis, to perform substantive tests directed at the possibility of fraud. The Panel recommendation also calls for auditors to examine non-standard entries, and to analyse certain opening financial statement balances to assess, with the benefit of hindsight, how certain accounting estimates and judgments or other matters were resolved.

The intent of this recommendation is twofold: to enhance the likelihood that auditors will be able to detect material fraud, and to establish implicitly a deterrent to fraud. This can be achieved by greater audit effectiveness which would pose a threat to perpetrators in successful concealment of fraud. The Panel also advocated stronger standard setting for auditors. It observed that the Auditing Standards Board should make auditing and quality control standards more specific and definitive to help auditors enhance their professional judgment. The Panel recommended that audit firms should review, and where appropriate, enhance their audit methodologies, guidance, and training materials; and peer reviewers should ‘close the loop’ by reviewing those materials and their implementation on audit engagements and then reporting their findings.

Audit firms should put more emphasis on the performance of high-quality audits in communications from top management, performance evaluations, training, and compensation and promotion decisions.
Summary

- All over the world, Not-for-Profit Organisations (NPOs) play an important role in the socio-economic process of the countries in which they operate.
- The magnitude of the funds channelled through these organisations creates considerable responsibility in terms of follow up, monitoring and accountability.
- Research Committee of the Institute of Chartered Accountants of India (ICAI) has recently brought out a research publication ‘Technical guide on Accounting and Auditing in Not-for-Profit Organisations’ elaborately explaining applicability of various accounting standards and other matters concerning accounting and auditing in such organisations.
- Many of the provisions of the central and state-level laws overlap in their application to not-for-profit organisations and registration of a charitable organisation under a particular enactment, central or state, does not necessarily make the organisation escape from other enactments.
- Fraud is an activity by a person who does his duty in a wrong way or refrains from doing his duty for some favours, i.e., financial, tangible, or anything else which is not due to him or them in the normal course.
- Two types of intentional misstatements are relevant to the auditor’s consideration of fraud-misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
- Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users.
- Fraud involves motivation to commit fraud and a perceived opportunity to do so.
- Internal auditors support management’s efforts to establish a culture that embraces ethics, honesty, and integrity. They assist management with the evaluation of internal controls used to detect or mitigate fraud, evaluate the organisation’s assessment of fraud risk, and are involved in any fraud investigations.

References


Recommended Reading

Self Assessment

1. Which of the following is a specific auditing and assurance standard pronounced by the ICAI (effective from April 1, 2003), relating to an auditor’s duty as regards ‘fraud and error’ in financial statements?
   a. AAS 3
   b. AAS 4
   c. AAS 5
   d. AAS 6

2. ___________ skills relate to gathering evidence, analysing the breakdown in controls that could enable a fraud, and making recommendations for improvement.
   a. Fraud
   b. Internal audit
   c. Cost audit
   d. External audit

3. When the ________ have the primary responsibility for fraud they must have the key competencies for this work - typically obtained through specialised training and related experiences.
   a. external auditor
   b. tax auditor
   c. cost auditor
   d. internal auditors

4. Match the following.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>A. The best practice is definitely training and setting examples.</th>
</tr>
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<tbody>
<tr>
<td>1. Evaluation of all internal control</td>
<td></td>
<td>B. A responsible person should be nominated to keep and eye on the controls where it is easy for someone to commit a fraud.</td>
</tr>
<tr>
<td>2. Check on business assets</td>
<td></td>
<td>C. Every act of an organisation matters, a single illegal act can affect the business and may destroy its reputation and goodwill in the market.</td>
</tr>
<tr>
<td>3. Keep check on the code of ethics or conduct of your employees</td>
<td></td>
<td>D. A good business man is one who keeps a control on his assets and liabilities.</td>
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<tr>
<td>4. Check on illegal acts</td>
<td></td>
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<tr>
<td>a. 1-D, 2-C, 3-B, 4-A</td>
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<tr>
<td>b. 1-A, 2-B, 3-C, 4-D</td>
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<td>c. 1-B, 2-D, 3-A, 4-C</td>
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<tr>
<td>d. 1-C, 2-A, 3-D, 4-B</td>
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5. Both, ________ as well as internal auditors are third party person.
   a. external
   b. cost
   c. tax
   d. statutory
6. Which of the following is one key source which outlines the major issues of a business?
   a. Audit committee
   b. Auditors recommendation
   c. Illegal acts
   d. Internal control

7. Area where cash handling is involved is particularly prone to__________.
   a. auditing
   b. accounting
   c. fraud
   d. prevent fraud

8. Planned fraud is again divided into _____ categories.
   a. two
   b. three
   c. four
   d. five

9. Which of the following category is famous for even killing all the internal controls?
   a. A group of people
   b. Forced fraud
   c. Accidental
   d. Unintentional

10. Fraud involving one or more members of management or those charged with governance is referred to as_______.
    a. employee fraud
    b. management fraud
    c. unintentional fraud
    d. planned fraud
Chapter VIII
Audit of Limited Companies

Aim
The aim of this chapter is to:

- introduce recent trends in auditing
- explain the role of supreme audit institutions
- describe cost audit

Objectives
The objectives of this chapter are to:

- elucidate tax audit
- explain management audit
- explicate objectives of cost audit

Learning outcome
At the end of this chapter, you will be able to:

- understand the requirements of tax audit
- identify the process of management audit
- define the purpose of tax audit
8.1 Recent Trends in Auditing

The decade of eighties is known for the spread of privatisation all over the world. There is a global development and expansion of this concept and there is no longer any doubt that it continues to be popular with all forms of Governments. The deteriorating profitability and increase in subsidies of State enterprises have further strengthened the belief that privatisation remains the only remedy to inject efficiency into public sector management.

Privatisation essentially means transfer of ownership from the State into the hands of non-state entities. There are, however, many transient forms of this process, for example, partial disinvestment, dilution of State ownership, contracting out certain functions, management buy outs etc. In every case however, the State decides to part with its assets or its right to manage them for a specific return. Since these assets were acquired out of the public funds and have grown in value over the years, it is in the public interest to ensure that the process of privatising them should be such as to get the best return for the exchequer.

It is here that the SAIs steps in. As independent institutions with constitutional mandate to guard the interests of the State exchequer, they are naturally involved in examining the process of privatisation at various stages not only to ensure that the State receives the best return out of the enterprise or the assets being privatised, but also to ascertain that the ultimate objectives of the privatisation are realised.

Role of supreme audit institutions

The improvement in the public finances of the country is now dependent, among other factors on the progress made in reforms of public sector management in general and State enterprises in particular. Privatisation is one of the important measures in this direction and the public has already come to bestow a good deal of faith on this approach. As an extension of this faith, they expect that independent institutions, such as the SAI, which have come to be viewed as a kind of trustee, would, while facilitating the transition, also provide from time to time, not only a report on the progress made, but also its opinion on whether the privatisation has achieved its objectives. More significantly, it is also expected that the SAI would identify the systemic and other bottlenecks that are hindering the implementation of these measures and suggest ways as to how they could be overcome.

This perception has driven almost all SAIs to undertake the audit of privatisations by accommodating such audits within their mandate and by applying both traditional audit techniques as well as newly acquired skills; in this process, they have contributed substantially to making the process of privatisation more transparent and accountable. In doing so, the SAIs have generally confined themselves to the following major areas of examination:

- Legality of transaction, where a specific law has been enacted or a specific mandate has been given by the legislature or clear guidelines have been laid down;
- Economy and Efficiency of the transaction, by examining whether the transfer or sale of public enterprise or assets has been done in such a way as to maximise the sale proceeds and minimise costs; and
- Effectiveness of the privatisation process, by ascertaining whether the objectives of the privatisation have been achieved.

The objectives of audit as well as the methods, techniques and focus of audit efforts however differ from country to country, since the methods of privatisation, the extent of development of financial markets, the level of competition and the resources deployed in this area differ widely. The State objectives in privatisation and the historical background as well as the legal mandate of the SAI in each country will also influence its approach in each case.

The audit of privatisation is yet to acquire deep roots in Asia, Africa and other developing countries. Most of the countries in this region have not initiated privatisation in a big way. Even where it has started, many SAIs have not got involved in its audit, although in most cases they do have statutory powers to do so. However, in some countries, SAIs have started assuming an important consultative role in the process.
In Egypt, the Central Auditing Organisation conducts as a part of its duties, the evaluation of privatisation programmes by studying and analysing the draft laws submitted by the Government to ascertain whether it contains the conditions of success and adequate precautions to ward off negative effects and expresses an opinion thereon. It also verifies the execution of programme as per the time schedule, contracting, sale and other transactions. The SAI continues to retain its audit jurisdiction, till the Government shareholding falls below 25%.

In Bahrain, public sector restructuring is in its early stages. As restructuring projects come to fruition, the role of SAI is expected to become more direct in the specific areas of system development audit and post implementation reviews. It expects to provide technical accounting support and peer advice through its membership of project review committees. On the same lines, the SAIs of Mauritius, Thailand and Zambia are in the process of getting involved in the audit of privatisation. In Indonesia, Brazil and Lesotho, the SAIs have yet to get involved in privatisation audit.

SAI-India has firmly established its jurisdiction within the existing legal framework and has successfully conducted the audit of partial disinvestment of the shares of Government companies conducted in 1992. This disinvestment programme, which yielded a sum of Rs. 30.38 billion (US $ 868 m.) to the Indian Government, aimed at disinvesting a part of the equity capital in respect of 30 public enterprises. The SAI’s Audit Report highlighted a number of interesting points. It observed that the sale was not conducted in a competitive environment and was restricted only to the handful of financial institutions in the public sector. It also brought out that since the shares were sold below the reserve prices originally computed on the basis of valuation, there was a loss of Rs. 344 bn. (US $ 10 bn.) to the Exchequer. Since there was no ‘claw back’ provision in the terms and conditions of the sale, the buyers made considerable profit as soon as the shares were offloaded in the market, from which Government derived no benefit. The report made considerable impact both in the Parliament and the media and the Government has initiated a number of corrective measures to streamline the procedures.

Apart from the fact that the privatisation process has not fully taken off in this region, one of the reasons for low key activity of SAIs in the audit of privatisation is that many SAIs are still in the process of equipping themselves for this task. Training and know-how for auditing in this complex area is one of the important inputs needed in this region. However as the process of privatisation gathers momentum, SAIs will also gear themselves to tackle this crucial area.

Audit of privatisation is one of the most complex issues faced by SAIs in their long and chequered history. It acquires new dimensions with the changing socio-economic and political situations. There are several areas which have proved difficult and elusive, one of them being the uncertainty about the value of business being sold and the consequent determination of the sale price. There can be no fixed formulae to solve these problems and every SAI has to make judgements to arrive at the best possible solution. Lack of experience of privatisation audit within the SAI, inadequacies in the existing market structure and inadequacies of legal provisions are some of the other major problems, but these are likely to get resolved with the passage of time.

The most encouraging feature in the recent trends in the audit of privatisation is the emerging strength of the SAIs and their role as independent advisors to streamline the systems to achieve better value for money. The proactive, positive and assertive role played by SAIs in the field of privatisation audit is a landmark in the evolution of state audit. It has exploded the myth that audit is merely a fault finding and negative function, and has underlined its crucial role in securing improvements in administrative systems to achieve greater economy, efficiency and effectiveness in governmental operations.
8.2 Cost Audit

Cost audit is the audit of cost records. According to Chartered Institute of Management Accountants, London (CIMA), cost audit is “the verification of the correctness of cost accounts and of the adherence to the cost accounting plan”. In other words, cost audit is the verification of the cost of production of any product, service or activity on the basis of accounts maintained by an enterprise in accordance with the accepted principles of cost accounting. This definitions of Cost Audit is relevant to the voluntary Cost Audit without any statutory backing.

The Institute of Cost and Works Accountants of India on the other hand, defines cost audit as “a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries.” Thus the concept and scope of cost audit as defined in India is more specific and lays emphasis on the evaluation of the efficiency of operations and the propriety of management actions as introduced by the Government of India for specified industries. In this sense, cost audit in India appears to be synonymous with efficiency audit mainly as a guide for management policy and decision making besides being a barometer of actual performance.

The justification for mandatory Cost Accounting and Cost Audit provisions has been very well explained in the Parliamentary Debate that led to the adoption of Companies Amendment Bill, 1965 incorporating the provisions related to Sections 209 (1) (d) and 233B. Smt. Tara Ramchandra Sathe (MP for Maharashtra) stated during the relevant Rajya Sabha Debate as below.

What is Cost Audit? The Cost Audit is quite different from the Financial Audit. It is to see whether the labour is Efficient or not, whether the industry has provided efficient labour or the labour which is required by that industry is less than what is required, whether every material and every part of the machinery is used to the optimum, whether any material is wasted, etc.

Thus Cost Audit in India refers to the statutory Cost Audit of the selected companies covered under the relevant provisions of the Companies Act, 1956. These requirements are mandatory and non-compliance may invite penal provisions also.

8.2.1 Features of Cost Audit

The cost audit of the companies under the relevant provisions of the Companies Act, 1956 has the following features:

- Assessing compliance of the relevant cost accounting records rules as applicable to the product under review;
- Study of the costing system to assess whether it is adequate for the cost ascertainment of the product under review;
- Evaluation of the operating and other efficiencies of the organisation under audit with special reference to the product under review; to ensure the submission of necessary details required under the Cost Audit Report Rules, 2001 as amended from time to time.
- Submission of Cost Audit Report in the format prescribed.

Since cost audit is carried out under the various provisions of the Companies Act, 1956, a thorough and comprehensive knowledge of the Indian Companies Act including various rules prescribed thereunder and the circulars issued by the Ministry of Corporate Affairs is essential for conducting an effective Cost Audit.

8.2.2 Objectives of Cost Audit

Cost Audit has both general and social objectives. The general objectives can be described to include the following:

- Verification of cost accounts with a view to ascertaining that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.
- Ensuring that the prescribed procedures of cost accounting records rules are duly adhered to.
- Detection of errors and fraud.
Verification of the cost of each “cost unit” and “cost centre” to ensure that these have been properly ascertained.

- Determination of inventory valuation.
- Facilitating the fixation of prices of goods and services.
- Periodical reconciliation between cost accounts and financial accounts.
- Ensuring optimum utilisation of human, physical and financial resources of the enterprise.
- Detection and correction of abnormal loss of material and time.
- Inculcation of cost consciousness.
- Advising management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement.
- Promoting corporate governance through various operational disclosures to the directors.

Among the social objectives of cost audit, the following deserve special mention:

- Facilitation in fixation of reasonable prices of goods and services produced by the enterprise.
- Improvement in productivity of human, physical and financial resources of the enterprise.
- Channelising of the enterprise resources to most optimum, productive and profitable areas.
- Availability of audited cost data as regards contracts containing escalation clauses.
- Facilitation in settlement of bills in the case of cost-plus contracts entered into by the Government.
- Pinpointing areas of inefficiency and mismanagement, if any for the benefit of shareholders, consumers, etc., such that necessary corrective action could be taken in time.

8.2.3 Scope of Cost Audit

Section 227(2) of the Companies Act, 1956, requires the auditor of a company to state whether the accounts in his opinion give a true and fair view of the state of the company’s affairs in the case of the balance sheet and of the profit or loss for its financial year in the case of the profit and loss account. Therefore, statutory financial audit of a company conducted by the Chartered Accountant is an essential annual feature of all the companies registered under the provisions of Companies Act, 1956. The Board of Directors of every company has a statutory obligation to place its audited annual accounts, viz., Profit and Loss Account and Balance Sheet before the shareholders in the Annual General Meeting, duly certified by a Chartered Accountant appointed as an ‘Auditor’ under the provisions of Section 224 of the Act. However, there is no corresponding statutory provision for compulsory annual audit of cost accounts of a company covered under Section 209(1)(d) of the Companies Act or under relevant Cost Accounting Records Rules.

One of the pre-requisites of cost audit is the maintenance of cost accounting records by the company. Section 209(1) (d) makes it obligatory for a company pertaining to any class of companies engaged in production, processing, manufacturing or mining to maintain such particulars relating to utilisation of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the Central Government to include such particulars in the books of accounts. The rules provide that only those companies, which are covered under Section 209(1)(d) of the Companies Act and a specific Cost Audit Order has been issued with reference to a specified product by the Cost Audit Branch of Ministry of Corporate Affairs are required to get their cost accounts audited with respect to that specific product. Moreover, Cost Audit Report is not placed before the shareholders during the Annual General Meeting.

The Central Government prescribes the separate cost accounting records for each class of companies, i.e., companies manufacturing a particular class of product or activity like Cement, Steel, Chemicals and Electricity etc. and these are called the Cost Accounting Records Rules for that specific industry or class of companies. When cost accounting records/formats are prescribed, they apply to those companies engaged in the manufacture of a particular product or activity. In the case of companies engaged in production or processing of other products or activities also in addition to production, processing or manufacture of the specified product, the records will have to be maintained only for the manufacture of particular product for which rules are issued and not necessary for other products.
A company manufacturing bulk drugs, formulation and watches need not necessarily maintain cost accounting records in respect of watch making activity if no statutory rules are prescribed for watch making activity. The detailed provisions relating to the manner of prescription of cost accounting records, selection of the product, the contents of the rules and the list of products/industries covered by the statutory rules under Section 209(1)(d) of the Companies Act have also been explained in Study Notes 2 and 3. Thus Cost Audit u/s 233B does not embrace a particular activity of the company unless a separate cost accounting record rule is already notified for that particular activity under Section 209(1)(d) detailing the nature of cost accounting records to be maintained.

The legal provisions relating to statutory cost audit are applicable only to companies registered under the provisions of Companies Act, 1956. Therefore, cost audit is not applicable to other enterprises like partnership, cooperative societies, etc. The Cost Audit is conducted by a Cost Accountant in practice within the meaning of the Cost and Works Accountants Act, 1959. The cost auditor is appointed by the Board of Directors of the company with the previous approval of the Central Government. The report of cost auditor is to rendered to the Central Government with a copy to the Company.

8.2.4 Cost Auditor

Issue of Cost Audit Order is the first step in Cost Audit of any company. The Central Government issues a specific order under Section 233(B)(1) of the Companies Act, 1956 on a particular company directing it to get its cost records audited by a practicing Cost Accountant indicating the product for which the order is issued and the period for which it is ordered. Therefore, the starting point for the cost audit exercise is the receipt of cost audit order by the company, specifying the year and the product for which such cost audit is to be conducted. However, the Cost Audit Branch has now been issuing Cost Audit Orders on regular basis to all the companies covered (i.e., every financial year thereafter continuously until further orders.) This amounts to saying that once an order is issued, the cost audit is required to be done every year unless it is specifically withdrawn. It may be clarified here that since the cost audit order issued by the Cost Audit Branch specifies the product, the Company need not have a cost audit for the product not specified in that order. Thus, if the company producing Sugar, Cement and Steel receives an order relating to Sugar for the year ending 31st March, 2009, then it need not get the cost records for products Cement and Steel audited under Sec. 233B for the year ending 31st March, 2009. Similarly for subsequent years also, it needs to get its cost records for Sugar only cost audited unless it gets a specific order on other products also.

8.2.5 Qualification of Cost Auditor

Section 233(B) of the Companies Act, 1956 provides that the Central Government may, if it considers necessary, direct that the audit of cost accounts kept by a company for a specified product or activity under Section 209(1)(d) shall be conducted by an auditor who shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959. In other words, the Sec. 233(B)(1), in so far as it relates to qualification of cost auditor provides that a person holding certificate of practice from the Institute of Cost and Works Accountants of India only can be appointed as a cost auditor. The cost auditor may be an individual cost accountant or a firm of cost accountants with at least two partners. A firm of cost accountants can be constituted with the previous approval of the Central Government/Institute as required under the regulation 113 of the Cost and Works Accountants Act, 1959 as amended from time to time and in which all the partners are cost accountants holding certificate of practice issued by the Institute of Cost and Works Accountants of India. Section 224 (1-B) of the Companies Act, 1956 further provides that a person can be appointed as a cost auditor only if he is not in full time employment elsewhere.

A provision to Section 233B(1) lays down that if the Central Government is of opinion that sufficient number of cost accountants within the meaning of the Cost and Works Accountants Act, 1959 are not available for conducting the audit of the cost accounts of companies generally, the Government may, by notification in the Official Gazette, direct that, for such period as may be specified in the said notification, such Chartered Accountant within the meaning of the Chartered Accountants Act, 1949, as possesses the prescribed qualification, may also conduct the audit of the cost accounts of companies. It may be clarified here that the Central Government has not so far issued any notification under the above provision.
There are several members of the Institute of Cost and Works Accountants of India (ICWAI), who have qualified the examination of both the Institutes namely ICWAI and the Institute of Chartered Accountants of India and thus are eligible for membership as well as certificate of practice from both the Institutes. However, none of the members can hold “certificate of practice” in more than one Institute under the provisions of both the Institutes. Therefore, practically there is no possibility of any financial auditor to practice as cost auditor or vice versa.

However, it is only in the background of the aforesaid proviso that Section 233B(5)(b) provides that a person appointed under Section 224 as an auditor of the company (financial auditor) shall not be appointed or re-appointed for conducting the audit of the cost accounts of a company (cost auditor of the same company).

8.2.6 Powers of a Cost Auditor

Section 233B(4) of the Companies Act, 1956 gives the cost auditor same powers as the financial auditor has under Section 227(1). In addition, Rule 6 of the Cost Audit Report Rules also requires the company and every officer thereof, including the persons referred to in sub-Section (6) of Section 209 of the Act to make available to the cost auditor, within 135 days from the close of the financial year of the company, such cost accounting records, cost statements, other books and documents, Annexure and proforma to the Report, duly completed as would be required for conducting the cost audit, and shall render necessary assistance to the Cost Auditor so as to enable him to complete the cost audit and submit his report within the time limit specified in rule 5. Section 233B(6) further provides that it shall be the duty of the company to give all facilities and assistance to the cost auditor so as to enable him to complete the audit and send the report within the prescribed time limit.

The powers of the cost auditor under sub-Section (1) of Section 227 are as under:

- Right to access at all times to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.
- Entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as an auditor.

8.2.7 Duties of a Cost Auditor

The duties of the cost auditor are also similar to those of the (financial) auditor of the company has under sub-Section (1) of Section 227 (Section 223B(4)). The duties of the cost auditor inter-alia include:

- To ensure that the proper books of accounts as required by Cost Accounting Records Rules have been kept by the company so far as it appears from the examination of those books and proper returns for the purpose of his audit have been received from branches not visited by him;
- To ensure that the Cost Audit Report and the detailed cost statements are in the form prescribed by the Cost Audit Report Rules by following sound professional practices, i.e., the report should be based on verified data and observations may be framed after the company has been afforded an opportunity to comment on them;
- The underline assumptions and basis for allocation and absorption of indirect expenses are reasonable and are as per the established accounting principles;
- If the auditor is not satisfied in any of the aforesaid matters, he may give a qualified report along with the reasons for the same;
- Sending the Report to the Cost Audit Branch within 180 days from the end of the financial year with one copy to the company;
- Sending his replies to any clarification, that may be sought by the Cost Audit Branch on his report. Sending such replies within 30 days from the date of receipt of communication calling for such clarification.
8.3 Tax Audit

September month is a Tax audit month. Tax audit is popularly known 44AB audit. This audit has to be completed on or before due date, i.e., 30th Sept.

The tax audit was introduced by insertion of a new section 44AB to the Income Tax Act, 1961 w.e.f 1st April, 1985. This section creates an obligation on a person carrying on business to get his accounts audited by a chartered accountant and to furnish by the specified date, the report in prescribed form of such audit, if the total sales, turnover or gross receipts in business in the relevant previous year exceed or exceeds Rs. 40 lakhs (increased to Rs. 60 lakhs from financial year 2010-11) 44AB comprises of 2 forms – Form 3CA/CB and Form 3CD. Every 44AB assessee need to file either Form 3CA or 3CB. But Form 3CD is must.

8.3.1 Purpose of Tax Audit

The purpose of tax audit as per CBDT circular no. 387, dated July 6, 1984 as under.

“Compulsory audit of accounts of certain persons carrying on business or profession :

- Accounts maintained by companies are required to be audited under the Companies Act, 1956. Accounts maintained by co-operative societies are also required to be audited under the Co-operative Societies Act, 1912. There is, however, no obligation on other categories of taxpayers to get their accounts audited.
- A proper audit for tax purposes would ensure that the books of account and other records are properly maintained, that they faithfully reflect the income of the taxpayer and claims for deduction are correctly made by him. Such audit would also help in checking fraudulent practices. It can also facilitate the administration of tax laws by a proper presentation of the accounts before the tax authorities and considerably saving the time of Assessing Officers in carrying out routine verifications, like checking correctness of totals and verifying whether purchases and sales are properly vouched or not. The time of the Assessing Officers thus saved could be utilised for attending to more important investigational aspects of a case.”

8.3.2 Books of Accounts and List of Documents/Papers Required for Tax Audit Purpose

Following are the books of accounts required:

- Cash Book
- Bank Book
- Journal
- All Ledgers
- Purchase Register
- Sales Register
- Stock Registers

Need to maintain supporting documents and vouchers for above accounts.

The necessary documentation for tax audit is listed below:

- All above books of accounts with supporting
  - Bank Passbook
  - Balance Sheet
  - Profit and loss account.
8.3.3 Standard Procedures or Steps for Tax Audit

The standard procedures for tax audit are:

- Send an appointment letter to Chartered Accountant in your official letter appointing him as auditor. Your appointment should have Ca Firm registration as per recent change. Please note that only CA has legal right to do Tax audit and he can sign only 45 tax audit in a year. Please confirm with him on this.
- Ask for Engagement Letter from Chartered Accountant for accepting your appointment. Please make sure that you maintain a copy of this letter as permanent record at least for 6 years. Get this engagement letter on his CA letter head with duly signed by him and date. Before sending engagement letter to you for your sign, CA needs to get “No objection letter” to previous tax auditor. This is mandatory as per ICAI guidelines and Professional code of ethics.
- During audit, CA may ask you to provide management representations – For closing stock valuation etc. Please provide the same to auditor
- Finally CA will give audit report in above mentioned forms – Form 3CA/Form 3CB and Form 3CD. Audit report should contain date, seal and sign of CA
- Mention CA name, PAN, Firm registration #, ICAI membership # with audit signed date while filing ITR 4. This needs to be done on or before 30th Sept to file Regular Return.
- PY Balance Sheet, PY Profit and Loss account and PY Tax Audit Report Forms needed for comparison study and reporting purpose

8.3.4 Requirements of Tax Audit

The purpose of Tax audit is to ensure proper maintenance of books of accounts and other records, in order to reflect the true income of the assessee and to facilitate the assessing officer to carry out the verification.

While conducting a tax audit, the following points need to be kept in mind:

- It is the primary responsibility of the assessee to give classified information for the purpose of tax audit. This is in the interest of an efficient conduct of tax audit.
- The Tax auditor has to ensure that the data he audits using Tally.ERP 9 is the final one.
- Audit Programme and the extent of Audit Procedures have to be planned according to the nature of business and operations of the client.
- Particulars given in Form 3CD have to be true and correct. The emphasis is on the accuracy of data extracted.
- The data extracted has to be further filtered to certain quantity / value limits as judged by the CA. The Concept of Materiality – AAS 13 has to be referred to while preparing the particulars to be reported.
- Print outs of particulars reported in Form 3CD should be duly signed by the authorised signatory, and be kept as working papers. AAS 3 - Documentation - Working Papers
- Many of the particulars require exercise of judgment by the tax auditor.
- Tally.ERP 9 is used only to generate various reports and required information, reporting of such information or not is subject to tax auditor’s judgment.
- The tax audit report is for an assessee. Details/ information should be consolidated where the enterprise has more than one division/ unit/ branch and accounts are maintained separately for each division/unit/ branch. Where an auditor is required to furnish tax audit report only in respect of a division/unit/ branch, details of the same should be mentioned in the Report.

8.3.5 Tax Auditor

The term “accountant” has been defined in sub-clause (i) of Explanation to section 44AB as under:-

“Explanation, - For the purposes of this section, -
(i) “accountant” shall have the same meaning as in the Explanation below sub-section (2) of section 288”.
The above-mentioned Explanation reads as under:

“Accountant’ means a chartered accountant within the meaning of Chartered Accountants Act, 1949 (38 of 1949) and includes, in relation to any State, any person, who by virtue of the provisions of sub-section (2) of section 226 of the Companies Act, 1956 (1 of 1956), is entitled to be appointed to act as an tax auditor of companies registered in that State.”

The proviso to section 44AB also lays down that where the accounts of an assessee are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person gets the accounts of such business or profession audited under such other law before the specified date and furnishes by that date the report of the audit as required under section 44AB. It may be noted that with the deletion of the words “by an accountant” in the proviso to section 44AB by the Finance Act, 1985 with effect from 1st April, 1985, in the case of any assessee like a co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a chartered accountant, the tax audit may also be conducted by the statutory auditor who may not be a chartered accountant.

Though the section refers to the accounts being audited by an accountant, which means a chartered accountant as defined above, the audit can also be done by a firm of chartered accountants. This has been a recognised practice under the Act. In such a case, it would be necessary to state the name of the partner who has signed the audit report on behalf of the firm. The member signing the report as a partner of a firm or in his individual capacity should give his membership number below his name.

Section 44AB does not stipulate that only the statutory auditor appointed under the Companies Act or other similar statute should perform the tax audit. The tax audit can, therefore, be conducted either by the statutory auditor or by any other chartered accountant in practice.

Tax audit under section 44AB being a recurring audit assignment, for expressing professional opinion on the financial statements and the particulars, the member accepting the assignment should communicate with the member who had done tax audit in the earlier year as provided in the Chartered Accountants Act. In the case of a person whose accounts of the business or profession have been audited under any other law (i.e., a company, a co-operative society, etc. which is required to get the accounts audited under a Statute) it is not necessary to communicate with the statutory auditor if he had not done tax audit in the earlier year. Attention of the members is invited to the detailed discussion in the publication of ICAI, “Code of Conduct” under clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 vide Appendix II.

The tax auditor should obtain from the assessee a letter of appointment for conducting the audit as mentioned in section 44AB. It is advisable that such an appointment letter should be signed by the person competent to sign the return of income in terms of the provisions of section 140. The tax auditor should get the statement of particulars, as required in the annexure to the audit report, authenticated by the assessee before he proceeds to verify the same. The tax auditor is required to submit his report to the person appointing him, viz., the assessee.

The appointment of the auditor for tax audit in the case of a company need not be made at the general meeting of the members. It can be made by the Board of Directors or even by any officer, if so authorised by the Board in this behalf. The appointment in the case of a firm or a proprietary concern can be made by a partner or the proprietor or a person authorised by the assessee. It is possible for the assessee to appoint two or more chartered accountants as joint auditors for carrying out the tax audit, in which case, the audit report will have to be signed by all the chartered accountants. In case of disagreement, they can give their reports separately. In this regard, attention is invited to paragraph 15 of the Statement on the Responsibility of Joint Auditors reproduced below: “No problem arises if the joint auditors are able to arrive at an agreed report. But, where joint auditors are in disagreement with regard to the report, each one of them would be justified in expressing his own opinion through a separate report. Even where more than two joint auditors are appointed, there is no question of majority or minority with regard to the joint audit report. Each auditor is entitled to express his own separate opinion and, in fact, it is his duty to do so.”
The responsibility of joint tax auditors will be the same as in the case of other audits, for example, audit under the Companies Act. For details relating to such responsibility, in the case of joint tax audit, reference may be made to “Statement on the Responsibility of Joint Auditors” issued by ICAI. The same is reproduced in Appendix III.

The position of a tax auditor for conducting audit under section 44AB will be considered as an office of profit. Therefore, the provisions of section 314 of the Companies Act, 1956 will be attracted when a relative of a director is appointed as a tax auditor of the company, if the remuneration thereof exceeds the limits prescribed in the aforesaid section. The necessary formalities will be required to be complied with as required under section 314.

### 8.4 Management Audit

Management audit or process audit is the audit of the management, i.e., evaluation of the mangers’ ability to manage. It may be defined as “the systematic independent appraisal activity, within an organisation, for a review of the management’s efficiency, in its decision making function.

It is concerned with appraising:

- Management’s accomplishment of organisational goals
- Management functions of planning, organising, directing and controlling.
- Adequacy of management’s decisions and action in attaining its objectives.

The management audit is a more recent concept. It focuses on results, evaluating the effectiveness and suitability of controls by challenging underlying rules, procedures and methods. Management audits, which are generally performed internally, are compliance audits plus cause-and-effect analysis. When performed correctly, they are potentially the most useful of the evaluation methods, because they result in change.

#### 8.4.1 Process of Management Audit

Management audit is a key internal control tool for managements and company boards to ensure that daily business operations are being carried out as per laid down rules and procedures. Thus, risk based Process Audit involves a host of activities like collection and analysis of data, physical verification and reconciliation of data generated, based on agreed standards. Thus, Process Audits also ensure that data collected by analysis of the entire or selected process of a company is used for further enhancing the efficiency and usability of the process.

The cornerstone of CRP team’s end-to-end solutions approach is obtaining a good understanding of the client’s business process and objectives including organisational structure, systems & processes, applications and data input and output. Key processes which are risk prone and are critical to meeting the business’s objectives are evaluated by using qualitative and quantitative information.

#### 8.4.2 Advantages of Management Audit

Process Audit is one of the key measures in ensuring the smooth and risk free running of any enterprise - business, government or social organisations. With corporations having multi-country, multi-location and multi-divisions, non-compliance becomes a high probability and human control and physical checks for each and every process becomes an unviable, cumbersome and a costly affair.

A Process Audit on regular interval helps an organisation ensure process compliance and monitoring. Also, a Process Audit helps in identifying areas of non-compliance, purposeful fraud or ignorance at an early stage and suggests means and ways to plug the same. Lastly, with changing business environment, Process Audits help in bettering existing processes, improving efficiency and adding quantifiable profits to the company.
8.4.3 Management Audit Report

The written report uses the medium by which the comments, criticism and recommendations of a management audit department are conveyed to the Board, to functional directors and to management in general. It follows, therefore, that audit reports crystallise the work of the management auditor and merit the closest consideration of all audit staff engaged in their preparation. Reports must be written with very great care after full consideration of the subject matter and with full regard to the fact that it is imperative that the report conveys exactly the right impressions on the reader. Management audit reports will inevitably cover a wide variety of subjects, reflecting as they do the many and ever increasing ramifications of management audit departments. Reports can be divided into four main categories.

- Reports prepared by the management audit staff after their visits to a unit.
- Periodical reports prepared by senior members of management audit department which summarise the main audit findings and recommendations for the period under consideration and which afford a concise review of the department’s activities for that period.
- Reports in the results of special investigation and inquiries.
- An annual audit report.

The right of the management auditor to report to the highest level is now well established in many organisations but in all cases responsible officials of the different units which have been subjected to audit, should be afforded the opportunity of discussing matters in the report concerning their departments before this is passed in final form to a higher level.
Summary

- The improvement in the public finances of the country is now dependent, among other factors on the progress made in reforms of public sector management in general and State enterprises in particular.
- The audit of privatisation is yet to acquire deep roots in Asia, Africa and other developing countries. Most of the countries in this region have not initiated privatisation in a big way.
- SAI-India has firmly established its jurisdiction within the existing legal framework and has successfully conducted the audit of partial disinvestment of the shares of Government companies conducted in 1992.
- The Institute of Cost and Works Accountants of India on the other hand, defines cost audit as “a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries.”
- Cost Audit in India refers to the statutory Cost Audit of the selected companies covered under the relevant provisions of the Companies Act, 1956.
- Cost Audit has both general and social objectives.
- Board of Directors of every company has a statutory obligation to place its audited annual accounts, viz., Profit and Loss Account and Balance Sheet before the shareholders in the Annual General Meeting, duly certified by a Chartered Accountant appointed as an ‘Auditor’ under the provisions of Section 224 of the Act.
- One of the pre-requisites of cost audit is the maintenance of cost accounting records by the company.
- The Central Government issues a specific order under Section 233(B)(1) of the Companies Act, 1956 on a particular company directing it to get its cost records audited by a practicing Cost Accountant indicating the product for which the order is issued and the period for which it is ordered.
- The cost auditor may be an individual cost accountant or a firm of cost accountants with at least two partners.
- The tax audit was introduced by insertion of a new section 44AB to the Income Tax Act, 1961 w.e.f 1st April, 1985.
- The purpose of Tax audit is to ensure proper maintenance of books of accounts and other records, in order to reflect the true income of the assessee and to facilitate the assessing officer to carry out the verification.
- Management audit or process audit is the audit of the management, i.e., evaluation of the mangers’ ability to manage.
- The written report uses the medium by which the comments, criticism and recommendations of a management audit department are conveyed to the Board, to functional directors and to management in general.

References


Recommended Reading

Self Assessment

1. ___________ essentially means transfer of ownership from the State into the hands of non-state entities.
   a. Public
   b. Privatisation
   c. Autonomous
   d. Government aided

2. Which of the following sentence is false?
   a. The deteriorating profitability and increase in subsidies of State enterprises have further strengthened the belief that privatisation remains the only remedy to inject efficiency into public sector management.
   b. The State objectives in privatisation and the historical background as well as the legal mandate of the SAI in each country will also influence its approach in each case.
   c. The audit of privatisation is yet to acquire deep roots in Asia, Africa and other developing countries.
   d. Audit of industrialisation is one of the most complex issues faced by SAIs in their long and chequered history.

3. Which of the following is the audit of cost records?
   a. Internal audit
   b. External audit
   c. Cost audit
   d. Management audit

4. According to __________, cost audit is “the verification of the correctness of cost accounts and of the adherence to the cost accounting plan”.
   a. CIMA
   b. ICAI
   c. ICWAI
   d. IIAI

5. __________ defines cost audit as “a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries.”
   a. CIMA
   b. ICAI
   c. ICWAI
   d. IIAI

6. Which of the following is the Tax audit month?
   a. April
   b. December
   c. March
   d. September

7. The tax audit was introduced by insertion of a new section 44AB to the __________.
   b. Companies Act, 1956
   c. Co-operative Societies Act, 1912
   d. Chartered Accountants Act, 194
8. The purpose of ________ is to ensure proper maintenance of books of accounts and other records, in order to reflect the true income of the assessee.
   a. Internal audit
   b. Tax audit
   c. Management audit
   d. Cost audit

9. The ________ should obtain from the assessee a letter of appointment for conducting the audit as mentioned in section 44AB.
   a. internal auditor
   b. cost auditor
   c. tax auditor
   d. statutory auditor

10. ____________ or process audit is the audit of the management, i.e., evaluation of the managers’ ability to manage.
    a. Internal audit
    b. Tax audit
    c. Management audit
    d. Cost audit
Case Study I

How a Private Investment Manager Utilised a Comprehensive Team to Successfully Raise Capital?

The issue
A large private alternative investment manager identified a market opportunity to raise capital and register shares with the SEC. Unfortunately, neither the manager nor a majority of its funds had ever maintained US GAAP compliant financial information in the past. In order to complete the desired capital raising, management needed to produce audited historical US GAAP information, make strides toward developing a Sarbanes-Oxley-compliant control environment, and prepare a complete registration statement for filing with the SEC.

Our approach
PwC identified a team of transaction specialists to advise the client throughout the multiple processes of data gathering, data conversion, financial statement preparation, audit coordination, registration statement preparation and responding to SEC questions and comments. The company encountered an enormous number of complex accounting issues and we worked beside them, advising them based on our experiences and insights to enable the client to arrive at its own well-considered conclusions. When it came time to convert the data, and prepare the financial statements, our team stayed with them, continuing to advise and counsel the company and its team of consultants throughout the process. Finally, our transaction specialists drew upon their extensive capital markets experience to counsel the company throughout the preparation of the registration statement, and responding to inquiries from the SEC.

The outcome
Thanks to a team effort of the company, its consultants, PwC Transaction Services specialists and others, the company was able to achieve its desired capital raising objectives. Many long hours were invested by all parties working and advising to prepare audited financial statements, together with a complete registration statement providing investors with clear, transparent descriptions of the company’s performance over its track record period so they could make informed investment decisions.


Questions
1. Which issue is prescribed in the above case study?

   Answer
   A large private alternative investment manager identified a market opportunity to raise capital and register shares with the SEC. Unfortunately, neither the manager nor a majority of its funds had ever maintained US GAAP compliant financial information in the past. In order to complete the desired capital raising, management needed to produce audited historical US GAAP information, make strides toward developing a Sarbanes-Oxley-compliant control environment, and prepare a complete registration statement for filing with the SEC.

2. State the approach to the issue mentioned in the above case study by PwC.

   Answer
   PwC identified a team of transaction specialists to advise the client throughout the multiple processes of data gathering, data conversion, financial statement preparation, audit coordination, registration statement preparation and responding to SEC questions and comments. The company encountered an enormous number of complex accounting issues and we worked beside them, advising them based on our experiences and insights to enable the client to arrive at its own well-considered conclusions. When it came time to convert the data, and prepare the financial statements, our team stayed with them, continuing to advise and counsel the company and its team of consultants throughout the process. Finally, our transaction specialists drew upon their extensive capital markets experience to counsel the company throughout the preparation of the registration statement, and responding to inquiries from the SEC.
3. Specify the outcome of the solution provided by PwC.

Answer
Many long hours were invested by all parties working and advising to prepare audited financial statements, together with a complete registration statement providing investors with clear, transparent descriptions of the company’s performance over its track record period so they could make informed investment decisions.
Case Study II

Implementation of a Local Internal Audit Function with a Financial Services Company

A financial services company (subsidiary of an international group) was considering the implementation of a local internal audit function in Luxembourg. The objective was to define which organisation would be cost effective (externalising the audit, appointment of an internal auditor or assigning the role to a member of the group).

Our approach

- Review the existing organisation (processes, human resources and systems) and identify key risks
- Evaluate the requirements and expectations of the Board of Directors and executive committee members
- Create an internal audit report template that includes specific reporting topics required by the Board of Directors
- Assist in designing the audit plan and audit programs
- Define and describe the scope of the internal auditor’s job
- Manage the internal auditor’s recruitment process
- Train the internal auditor
- Provide quality review of audit reports.

The outcome

- Creation of a cost effective internal audit department in Luxembourg
- Significant improvements to the company’s organisation
- Improvement of reporting process to the Board of Directors


Questions

1. State the issue faced by the financial services company.
2. Mention the measures taken for the issue in the above case study.
3. What is the outcome of the approach?
ICAI Seeks Jail in Audit Fraud Cases

The Institute of Chartered Accountants of India (ICAI) has recommended strict penal action, including imprisonment, for auditors who are found associated with serious accounting frauds. It also wants the Ministry of Corporate Affairs to frame a code of conduct for financial analysts and investment bankers for better scrutiny of firms that may indulge in such illegal affairs.

The recommendations are part of ICAI’s final report on Satyam scam and the role of Satyam’s former statutory auditors from global auditing firm PriceWaterhouseCoopers. The report, finalised by ICAI’s highest decision-making council a few days ago, would be submitted to the ministry this week.

According to sources, ICAI has recommended strict action against auditors known to have collided with Satyam’s former promoter Ramalinga Raju in committing fraud. The committee has also recommended fresh scrutiny of the account books of all associate firms and subsidiary companies of the Raju family. ICAI officials confirmed that its apex council had finalised the report on May 13, but declined to provide details.

An ICAI sub-committee, which carried out extensive inquiry into the scam in January this year, submitted its report to the institute’s council. The sub-committee report prima facie found fault with PriceWaterhouse auditors S Gopalakrishnan and S Talluri, and recommended disciplinary action, including a professional ban on the two individuals. The central council of ICAI took time to firm up its views on the report as it wanted the accused auditors to be given a fair chance to present their case.


Questions

1. The Institute of Chartered Accountants of India (ICAI) has recommended strict penal action, including imprisonment, for auditors who are found associated with whom?
2. State the recommendations of the ICAI sub-committee report mentioned in the above case study.
3. The above case study is related to which fraud case?


Recommended Reading

- Basu, C. R. Commercial Banking in the Planned Economy of India. Mittal Publication.
Self Assessment Answers

Chapter I
1. b
2. c
3. d
4. c
5. b
6. a
7. c
8. d
9. a
10. c

Chapter II
1. a
2. c
3. d
4. b
5. c
6. b
7. a
8. b
9. a
10. d

Chapter III
1. b
2. a
3. d
4. b
5. a
6. d
7. d
8. c
9. d
10. a

Chapter IV
1. c
2. b
3. d
4. b
5. a
6. c
7. b
8. c
9. a
10. c
Chapter V
1. b
2. c
3. a
4. d
5. c
6. c
7. c
8. b
9. c
10. d

Chapter VI
1. c
2. a
3. d
4. a
5. b
6. b
7. b
8. a
9. c
10. a

Chapter VII
1. b
2. b
3. d
4. c
5. d
6. a
7. c
8. a
9. a
10. b

Chapter VIII
1. b
2. d
3. c
4. a
5. c
6. d
7. a
8. b
9. c
10. c